RECOMMENDATIONS OF SECURITIES AND EXCHANGE COMMISSION FORUM ON SMALL BUSINESS CAPITAL FORMATION

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
TAX, ACCESS TO EQUITY CAPITAL AND
BUSINESS OPPORTUNITIES

OF THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

WITH THE

SUBCOMMITTEE ON
URBAN AND RURAL ECONOMIC DEVELOPMENT

OF THE

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RECOMMENDATIONS OF SEC FORUM ON SMALL BUSINESS CAPITAL FORMATION

WEDNESDAY, DECEMBER 1, 1982

JOINT HEARING, HOUSE OF REPRESENTATIVES, SUBCOMMITTEE ON TAX, ACCESS TO EQUITY CAPITAL AND BUSINESS OPPORTUNITIES, COMMITTEE ON SMALL BUSINESS, WITH THE U.S. SENATE, SUBCOMMITTEE ON URBAN AND RURAL ECONOMIC DEVELOPMENT, COMMITTEE ON SMALL BUSINESS,

Washington, D.C.

The subcommittees met, pursuant to notice, at 2:08 p.m., in room 2359-A, Rayburn House Office Building, Hon. Henry J. Nowak (chairman of the House subcommittee) and Hon. Alfonse M. D'Amato (chairman of the Senate subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN NOWAK

Representative NOWAK. The committee will come to order. We want to start the hearing and I am anxious to hear the witnesses. It is a pleasure to jointly share this most important hearing regarding the recommendations of the Securities and Exchange Commission's "Government-Business Forum on Small Business Capital Formation."

The SEC forum which took place over a period of 2½ days in September was attended by nearly 200 spirited representatives of small business. The professions and the Government were represented as well. While attending the September conference, I was impressed by the seriousness of debate among all the participants. The attendees were certainly well versed and informed as to the current capital formation problems facing small business.

In particular, the forum participants clearly understood the need to find ways to increase the external and the internal cash flow of small business.

As chairman of the Subcommittee on Tax, Access to Equity Capital and Business Opportunities, I have conducted countless investigations regarding the impact of the tax, banking and security laws on small business. These areas of the law are clearly the heart of capital formation and, accordingly, are the heart of the forum recommendations being presented here today.

I and other members have been active proponents of many of the tax recommendations made by this forum. During the 1981 tax debate, I testified before the House Ways and Means Committee on such proposals, including such broad proposals as subchapter S reform, the need to dramatically reduce the rate for smaller corpo-

rations and firms and the importance of inventory accounting reform.

Further, with the cosponsorship of other committee members, I introduced the major piece of House legislation in 1982, calling for a 2-year delay in the implementation of the so-called section 385 debt-equity tax regulation.

The forum participants, I think, were very perceptive understanding the mood and the direction of this country. While we are experiencing a dramatic deregulation of the country's financial markets, they incisively made recommendations for the utilization of venture capital, institutional money, and pension funds for the spurring of small business investment. For example, if we could encourage pension fund managers to invest just 5 percent of their assets in small business, we would have directed over $25 billion in financing to this most important sector of the economy.

With this in mind, I welcome Chairman Alfonse D'Amato, who is the distinguished Senator from New York, the other Members of Congress here, and the witnesses, to this rare joint hearing.

A Senator agreeing to come to the House side is not unheard of, Senator. Usually we meet someplace in the middle between the House Office Buildings and the Senate. I want to commend you on your great interest and the time and energy that you put into this matter and for joining us here today.

Senator D'Amato, of course, is a subcommittee chairman himself on the Senate Small Business Committee, and I am sure the SEC forum recommendations will serve as a basis for future agendas on capital formation for both our committees.

I would now like to present small business' good friend, Senator D'Amato.

Senator D'AMATO. Thank you very much, Mr. Chairman, I am delighted to be able to participate with you in what I think is a very important hearing. I think it is appropriate that we help publicize the 37 recommendations of this forum, the first forum of its type, the forum that was legislated by Congress so that we could specifically hear from small and medium businesses, and get their input. I am looking forward anxiously to Commissioner Evans' remarks with respect to that forum and those 37 recommendations.

I, too, have some very important objectives in terms of a small business committee program. These relate to the section 503 and pollution control loan programs and the implementation by the SBA of industrial development bond financing.

So that we can get to the business of the day, I am going to ask that not only my opening statement be entered into the record as if read in its entirety, but also that of my colleague, Senator Sasser from Tennessee, who has asked that his statement be placed into the record.

Representative NOWAK. Senator, those statements will be admitted without objection.

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO, CHAIRMAN, SENATE SUBCOMMITTEE ON URBAN AND RURAL ECONOMIC DEVELOPMENT

Senator D'AMATO. As required by the Small Business Investment Incentive Act of 1980, the Securities and Exchange Commission this year conducted the "First Annual Government-Business Forum on Small Business Capital Formation." An important two-way channel of communication was opened between Government and small business representatives. The forum featured wide ranging discussions of the tax, financing, and capital formation needs of small- and medium-sized businesses. Nearly 200 individuals from both the private and public sectors participated. After due deliberation, a comprehensive list of 37 recommendations was voted on and agreed to.

Today these recommendations and their accompanying final report will be officially unveiled by SEC Commissioner John Evans who served as chairman of the executive committee of the forum. I welcome him here. Many of these recommendations may serve as the Small Business Committee's agenda on capital formation in the next Congress. It is for this reason that I hope that all of the witnesses today will comment specifically on their views of the merits of the various forum proposals.

On some of these recommendations which are especially important to me, I should point out that I have already made up my mind. For example, I wholeheartedly support the expansion of the small business section 503 loan program and I am a strong proponent of SBA participation in projects which also utilize industrial development bond financing. Other proposals have to be carefully studied. We have to pay careful attention to their costs, their likelihood of promoting small business capital formation, and their implications for equity.

In sum, however, I believe that the SEC forum was a great success. Important strides were taken at this first annual event. The resulting recommendations are well worth careful consideration by both the executive and legislative branch.

[Senator Sasser's prepared statement follows:]

OPENING STATEMENT OF HON. JIM SASSER, A SENATOR IN CONGRESS FROM THE STATE OF TENNESSEE

Mr. Chairman, I am pleased that this committee is addressing itself to one of the most pressing concerns facing small businesses today: capital formation. Those of us who have had continued contact with individuals in the small business community hear the topic of capital formation come up again and again. We live in a highly competitive society where the ability to raise large amounts of capital for new businesses is critical to economic survival. Unfortunately, we face a situation where we seem to have a shortage of long-run investment funds for businesses that do not have high earnings out of which they can save to finance their own future investment.

The issue of raising funds for a small business is a multifaceted topic. Credit conditions on the national level have had a serious effect on the ability of small businesses to obtain financing. Continued high interest rates have driven many small concerns out of business and prevented other individuals from establishing independent enterprises. Overall credit conditions, only slightly improved, will continue to have a drastic impact on the ability of small businesses to raise funds in the future.

Another concern in this area is the fear that the growth of interstate banking will lead to the demise of small commercial banks, thereby ending one outlet for small

businesses to obtain credit and financial services. This is a disturbing trend that warrants close scrutiny in the months ahead.

A related concern has been the recent rash of mergers between corporate Goliaths. Often these battling giants tie up vast amounts of capital in their efforts to overtake one another. This is money that may have gone to an individual attempting to start up a small business or to a fledgling small concern trying to stay in business.

Fortunately, all is not bleak in the world of capital formation for small business. We have seen large banks and financial institutions begin to pay more attention to financing small businesses. There have been some that have established special units to meet the needs of the small business person. While there are by no means enough large banks working to better assist small businesses, this is an encouraging trend and one that I hope to see continued.

Furthermore, despite the encroachment of interstate banks, some smaller banks have been able to compete rather successfully with their larger counterparts. This is due in large part to the fact that these local banks are more familiar with the area and are likely to have a long relationship with local businessmen. In addition, the advent of modern computer technology is allowing the upgrading of services and capabilities these smaller banks can offer their customers.

These are bright spots, but they are only a beginning. We need to search out other avenues of expanding the available capital market for small businesses. It is in this spirit that these hearings are held. I look forward to hearing the recommendations our witnesses have to make on this important topic.

Representative NOWAK. I would next like to present to our witnesses, and ask him to make an opening statement, someone who has encouraged the Small Business Committee to move forward on many of these fronts and certainly has been a true leader in trying to stimulate small business and the small business economy throughout our Nation, the Chairman of the House Small Business Committee, Mr. Parren Mitchell.

OPENING STATEMENT OF HON. PARREN J. MITCHELL, CHAIRMAN, HOUSE COMMITTEE ON SMALL BUSINESS

Representative MITCHELL. Thank you very much. I want to commend both you and the Senator and all others involved, for putting on this hearing. I think it is enormously significant. During my 12-year tenure in Congress, one of the things that I regretted most was the fact that very often we would have forums and seminars and there was really no followthrough on the recommendations.

Since you have been the chairman of the subcommittee, and I am certain the same thing is happening on the Senate side right now, I see much more followthrough, rather than just to meet for the purpose of meeting. I am very pleased to announce, as you probably know, that the House Small Business Committee followed through on most of the recommendations that came out of the White House Conference on Small Business.

Indeed, we have managed to get into law some of the recommendations that came from that conference, so I am delighted that you are having this hearing. I am delighted that you invited me to attend. There is another hearing going on simultaneously, and that frequently happens in Congress where we have two meetings going on at the same time. The House Subcommittee on Banking is meeting at 2, and I told them that I would join them at around 3, because I did want to participate in a part of this hearing.

Thank you and please accept my commendations for this effort.

Representative NOWAK. Thank you very much, Mr. Chairman. After we digest this we will, as always, make a distribution not only to our own members, but to the members of the other commit-

tees who may be affected by the recommendations and changes in legislation. We are very pleased that you are able to be with us, and I know that the committee has your strong backing to proceed in that manner.

The first witness we would like to bring before the committee is Commissioner John R. Evans, who has been a member of the Securities and Exchange Commission since 1973, and served as Chairman of the executive committee of the SEC small business forum.

He was previously a member of the professional staff of the U.S. Senate Committee on Banking, Housing and Urban Affairs. He is an economist who received his professional degrees from the University of Utah.

Commissioner Evans, it is a pleasure to have you appear before this committee. As we discussed during the forum, I think it was very meaningful. Certainly you are to be congratulated for putting the time and effort that you have into this forum and following through with it at this hearing.

TESTIMONY OF HON. JOHN R. EVANS, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION

Mr. EVANS. Thank you very much, Chairmen Nowak and D'Amato, other members of the committees.

I am pleased to appear before you today to discuss the first SEC "Government-Business Forum on Small Business Capital Formation." With me today are a number of the SEC staff people who were very much involved in the forum and whom I would like to introduce if that is appropriate.

Representative NOWAK. Fine.

Mr. EVANS. To them goes a lot of the credit for the forum's success.

Representative NOWAK. If they would like to join you at the table, that would be perfectly all right.

Mr. EVANS. There are probably too many to do that, but I would like to at least give their names: Lee Spencer, who is the director of our division of corporation finance, Mary Beach, who is an associate director of that division, and Paul Belvin, who is the chief of our office of small business policy.

In addition, other members of the staff who were very much involved are Matthew Schneider, senior special counsel, and Steven Holtzman, Daniel Abdun-Nabi, and Betsy Goodell, all of whom were staff counsel for the forum itself.

Representative NOWAK. So if we have any questions regarding any portion, they are available to answer any further questions.

Mr. EVANS. Yes.

Representative NOWAK. We are going to leave the record open to develop some of the details that will be needed before a complete record is developed and presented to other committees. We appreciate their presence here and your identification as to their expertise, so we may contact the individuals as the need arises.

I might just mention also that all of the formal statements that have been prepared by this witness and other witnesses will be admitted in total into the record. If you wish to summarize what is in

the testimony, we would appreciate it. We will then proceed on to questions.

Mr. EVANS. I would like to present a brief overview of the forum itself and encourage you and other Members of Congress to very carefully consider the recommendations that were arrived at by this group of people.

According to your schedule, a number of those who were on our executive committee will be testifying. Among them are Peter McNeish, Prof. Howard Stevenson, and Frank Swain. These people were actively involved in the planning of the conference. In addition, here with us today are Herb Spira of the National Small Business Association, Bob Greer of the American Stock Exchange and Jerry Feigen of the Small Business Administration.

As has already been stated, the forum was held pursuant to the Small Business Investment Incentive Act of 1980, which directs the Securities and Exchange Commission to conduct an annual Government-business forum "to review the current status of problems and programs relating to small business capital formation." Congress also directed that other Federal agencies be involved in the forum and that we also work closely with State agencies and organizations within the private sector who have a great interest in small business capital formation. In my view, the legislation which brought about this forum reflects a growing awareness of the importance of small business to the national economy and of the continuing capital formation problems which small businesses encounter.

On behalf of the forum's executive committee, I am pleased to transmit the final report of the forum. The recommendations contained therein reflect the majority views of the forum participants who met in Washington for a 3-day period in September to develop and debate proposals designed to enhance the ability of small businesses to obtain capital. It should be understood that the Securities and Exchange Commission did not seek to influence the substance of the findings or recommendations contained in the report, nor has the Commission taken a position on any of the particular recommendations at this time.

Planning for the forum began in March of this year when members of the Securities and Exchange Commission staff, whom I have already identified, helped to assemble an executive committee of 21 representatives from private sector organizations and Government agencies in accordance with the congressional guidelines. We received considerable cooperation from people at other Government agencies and also from private sector organizations who served as members of the executive committee and shared their expertise and experiences relating to small business capital formation. Participants in the forum were invited on the basis of their interest and expertise. Approximately 200 persons from throughout the Nation attended the forum, including many small business persons, accountants, attorneys, venture capitalists, bankers, broker dealers, academicians, and Government officials. The executive committee encouraged maximum participation by small business persons and invited all who indicated an interest to attend. In addition, members of the executive committee actively sought other prospects.

These efforts resulted in about 30 percent of the participants being from small businesses.

The forum substance and procedures were guided by the executive committee, which established task forces to examine small business capital formation problems in four areas: Access to financial institution; raising capital; taxes, and credit. Despite their expertise, the executive committee desired additional input concerning the most useful measures that could be undertaken to encourage capital formation. Thus, the Commission and the Financial Reporting Institute of the University of Southern California sponsored a survey to determine the views of small business executives. Based on the results of this survey and the guidance of the task force members, the SEC staff prepared eight issue papers which were sent to participants in advance of the forum. These issue papers contained various proposals and were designed to focus attention on those problem areas. Each of those who were invited to the forum were asked to be able to lead a discussion on one of the issues included in the papers. Most of the forum was devoted to consideration of the proposals in working groups of fewer than 20 persons. On the final day of the forum, the participants met in plenary session to debate and vote on the final proposals. Most of the proposals in the issue papers, and a number of additional proposals developed during the forum working sessions, were approved. The recommendations proposed various forms of regulatory or legislative action to enhance the capital formation process of small businesses. Some of these proposals would require only minor adjustments in present programs or the implementation of current policy. In one case, for instance, it was merely proposed that an existing policy be made more public so that more people would realize that it existed. Other proposals are quite innovative and would require the approval of new financing tools for small businesses.

In my prepared remarks, I have listed the eight categories in which these recommendations generally fall. All of the subjects listed in those eight categories are important and have a direct bearing on small business capital formation.

You will note, however, that the subject of interest rates was not directly addressed in the recommendations. The executive committee and the credit task force were aware that high interest rates represent one of the most important problems facing small businesses today, and other businesses as well. Indeed, the survey undertaken for the forum revealed that 93 percent of the respondents thought that reducing interest rates is the most important means of improving the ability of small business to secure credit financing. However, after careful consideration and a great deal of discussion, the executive committee concluded that the subject of interest rates and the various proposed solutions, such as revisions to the Federal Reserve Board monetary policy, removal of the board's independence, and passage of a balanced budget constitutional amendment, are of such magnitude and political significance that their discussion at the forum might have precluded an adequate discussion of other important issues.

Thus, the interest rate question was developed in an alternative format and was the subject of much interest and discussion at the forum. Lyle E. Gramley, a member of the Board of Governors of

the Federal Reserve System, accepted an invitation to speak about the problem of high interest rates at a luncheon. He also responded at length to questions and comments by forum participants.

Although Government officials made significant contributions to the work of the forum, it is clear to me that the key ingredient to its success was the effective work of the many private sector participants who came to Washington at their own expense and gave freely of their time and expertise. I think one of the reasons we did not have more small business people than we did, was the cost of coming to Washington and the difficulty of leaving their businesses for that period of time.

Small business is a vital segment of our national economy. Various studies indicate the importance of small business establishments in the creation of new jobs and important technological innovations. I am hopeful that in coming months, Congress and the various Government agencies whose programs would be affected by the forum's recommendations will give them careful consideration. I can assure you that the Securities and Exchange Commission will seriously consider the proposals that fall within our jurisdiction and we will be urging other Government agencies whose programs and policies would be affected by the recommendations to do likewise.

The forum helped to affirm the Government's interest in the small business sector of the economy and was a valuable step in bringing the Government and private sectors together to work for an improved environment that will facilitate small business capital formation. I am grateful to have had the opportunity to continue to participate in this undertaking.

Now I would be pleased to respond to any questions that members of the committees may have.

[Mr. Evans' prepared statement follows:]

PREPARED STATEMENT OF HON. JOHN R. EVANS, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION

I am pleased to appear before you today to discuss the first SEC Government-Business Forum on Small Business Capital Formation. As Chairman of the Executive Committee of the Forum, I would like to present a brief overview of our efforts and encourage you and other Members of Congress to give careful consideration to the proposals for legislative changes. According to your schedule, a number of other witnesses will discuss many of the 37 recommendations approved by the Forum participants. Among those from whom you will hear are Peter McNeish, Professor Howard Stevenson, and Frank Swain who were members of the Forum's Executive Committee and were actively involved in its planning and execution.

The Forum was held pursuant to the Small Business Investment Incentive Act of 1980, which directs the Securities and Exchange Commission to conduct an annual government-business forum "to review the current status of problems and programs relating to small business capital formation." Congress also directed that other Federal agencies concerned with small business capital formation, such as the Department of the Treasury, the Board of Governors of the Federal Reserve System, and the Small Business Administration should participate in the Forum. In addition, the legislation requires that the Commission work closely with organizations representing state securities commissioners and leading small business and professional organizations concerned with capital formation. In my view, the legislation reflects a growing awareness of the importance of small business to the national economy and of the continuing capital formation problems which small businesses encounter.

On behalf of the Forum's Executive Committee, I am pleased to transmit the final report of the First Annual SEC Government-Business Forum on Small Business Capital Formation. The recommendations contained therein reflect the majority views of the Forum participants who met in Washington for the three-day period of

September 23 through September 25, 1982, to develop and debate proposals designed to enhance the ability of small business to obtain capital.

It should be understood that the Commission has not sought to influence the substance of the findings or recommendations contained in the report, nor has it taken a position on any particular recommendation at this time. Moreover, as Chairman of the Forum, I requested that Federal government officials not participate in the voting on proposals which took place at the final Forum session. This policy resulted in one proposal which received a tie vote not being approved by the Forum.

Planning for the Forum began in March of this year when the Commission staff, led by Mickey Beach, Associate Director, Division of Corporation Finance, and Paul Belvin, Chief, Office of Small Business Policy, helped to assemble an Executive Committee of 21 representatives from private sector organizations and government agencies in accordance with Congressional guidelines. We received considerable cooperation and support from representatives of other government agencies who served on the Executive Committee and provided resource materials and expertise. We were also greatly assisted by the many private sector organizations that contributed their valuable resources and first-hand experience in many areas related to small business capital formation.

Participants in the Forum were invited on the basis of their interest and expertise. Approximately 200 persons from throughout the nation attended the Forum, including many small business persons, accountants, attorneys, venture capitalists, bankers, broker-dealers, academicians, and government officials. The Executive Committee encouraged maximum participation by small business persons and invited all who indicated an interest in attending. In addition, members of the Executive Committee actively sought other prospects. These efforts resulted in about 30 percent of the participants being from small businesses.

The Forum's substance and procedures were guided by the Executive Committee, which established task forces to examine small business capital formation problems in four areas: 1) access to financial institutions, 2) raising capital, 3) tax, and 4) credit. Although its members were generally familiar with the problems confronting small business, the Executive Committee desired additional input concerning the most useful measures that could be undertaken to encourage capital formation. Accordingly, the Commission and the Financial Reporting Institute of the University of Southern California sponsored a survey to determine the views of small business executives. Based on the results of this survey and the guidance of the task force members, the SEC staff prepared eight issue papers which were sent to participants in advance of the Forum. These issue papers, which were designed to stimulate discussion and help participants focus their attention on specific problem areas, contained a number of proposals to encourage small business capital formation.

Most of the Forum was devoted to consideration of those proposals in working groups of fewer than 20 persons. On the final day of the Forum, the participants met in a plenary session to debate and vote on the final proposals. Many of the proposals in the issue papers and a number of additional proposals developed during the Forum working sessions were approved. In general, the recommendations propose various forms of regulatory or legislative action to enhance the capital formation process for small businesses. Some of the proposals would require only minor adjustments in the operation of existing programs or the implementation of current policies. Other proposals are quite innovative and would require the approval of new financing tools for small business.

The recommendations fall within the following eight subject areas:

(1) Developing incentives for institutional investors and others to invest in small business;

(2) Relaxing ERISA and similar regulatory restrictions to encourage investment in small business;

(3) Reducing costs associated with securities regulation;

(4) Developing uniform Federal/State securities regulation;

(5) Adjusting corporate tax rates and brackets to reflect the internal capital raising needs of small business;

(6) Changing the tax treatment of capital gains to provide a stimulus to capital formation, particularly for smaller businesses;

(7) Providing additional tax modifications to assist small business capital formation and retention; and

(8) Revising Small Business Administration programs to assist the financing of small business.

All of these subjects have an important and direct bearing on small business capital formation. However, you will note that the subject of high interest rates was not directly addressed in the recommendations. The Executive Committee and the

Credit Task Force were aware that high interest rates represent one of the most significant problems facing small businesses today. Indeed, the survey undertaken for the Forum revealed that 93 percent of the respondents thought that reducing interest rates is the most important means of improving the ability of small business to secure credit financing. However, the Executive Committee believed that the subject of interest rates and the various solutions that have been proposed, such as revisions to Federal Reserve Board monetary policy, removal of the independence of the Board, and passage of a balanced budget constitutional amendment are of such magnitude and political significance that their discussion at the Forum might have precluded full discussion of the other issues selected.

Although not addressed directly in the recommendations, the interest rate question was developed in an alternative format and was the subject of much interest and discussion at the Forum. The Honorable Lyle E. Gramley, a Member of the Board of Governors of the Federal Reserve System, addressed the interest rate problem at a Forum luncheon and responded at length to questions and comments from Forum participants.

Although government officials made significant contributions to the work of the Forum, it is clear that the key ingredient in its success was the effective work of the many private sector participants who came to Washington at their own expense and gave freely of their time and expertise.

Small business is a vital segment of our national economy. Various studies indicate the importance of small business establishments in the creation of new jobs and important technological innovations in the United States. In this context, the efforts of the Forum take on particular significance. I am hopeful that in the coming months Congress and the various government agencies whose programs would be affected by the Forum's recommendations will give them careful consideration. I can assure you that the Securities and Exchange Commission will seriously consider the proposals that fall within our jurisdiction, and we will be urging other government agencies whose programs and policies would be affected by the recommendations to do likewise.

The Forum helped to affirm the government's interest in the small business sector of the economy and was a valuable step in bringing the government and private sector together to work for an improved environment that will facilitate small business capital formation. I have been very pleased with the many letters and other favorable comments on the Forum and am grateful for having had the opportunity to participate.

Representative NOWAK. Thank you very much. Let me pose the obvious. Has the SEC looked at a substantive range of options that were presented.

Mr. EVANS. Some of the items presented or recommended by the forum are ones that the SEC has looked at and will continue to look at. We are always interested in seeking new ways to lessen the burden on small business, and any business as a matter of fact. Some of the recommendations, as you might expect, parallel some of the things we have been doing at the SEC. Some of them go further than we have gone, but as I have stated in my prepared remarks, our staff will give careful consideration to these items and the Commission will seriously weigh the staff recommendations.

Representative NOWAK. Thank you very much. As you know, what we are doing here will affect many different committees of the House and Senate.

What we hope to do is inform those who would be substantively affected by any of these recommendations, as to how they developed, and the details involved in each recommendation.

We have received a communication from Tim Wirth, who is the chairman of the Subcommittee on Telecommunications, Consumer Protection, and Finance of the Committee on Energy and Commerce. He has some very important jurisdictions that we would be concerned with as a result of these hearings, and I want to read a

letter which he asks that we do put into the record concerning his responsibilities in this area.

I will have Benson read the letter into the record.

Mr. GOLDSTEIN. It was addressed to Hon. Henry J. Nowak and Hon. Alfonse M. D'Amato, chairmen:

[Letter referred to above follows:]

Gentlemen, I would like to commend you for holding this hearing on the report of the SEC Government-Business Forum on Small Business Capital Formation. As you know, the Forum was conducted pursuant to the Small Business Investment Incentive Act of 1980, which originated in the predecessor subcommittee to the Subcommittee on Telecommunications, Consumer Protection and Finance.

This subcommittee's interest in the findings of the Forum, particularly as they affect capital formation and the capital markets, has been longstanding.

As you are aware, small business has played an increasingly important role in this Nation's economy, particularly in terms of job creation, which has become the major concern of the Congress and the Nation.

Small businesses have played a dominant role in terms of technical innovation which makes our industries competitively strong in international markets. In recent years, high interest rates and economic downturns have impacted especially harshly on small business as witnessed by record high business failures.

There is an urgent need to develop mechanisms to allow greater small business access to our Nation's capital markets.

While I note that these proposals of the Forum to the securities laws deal with a recommended rule change by the SEC, I believe it is important to review these proposals, keeping in mind the basic premises of investor confidence and investor protection.

Investor confidence in the markets is the key to capital formation. The regulatory scheme administered by the SEC pursuant to the securities laws has for many years fostered that confidence, and rule changes made by the SEC must be scrutinized to assure that they are consistent with investor protection.

Because of our shared interest in these issues, we stand ready to help in any way in your efforts to assure that small business is assured proper access to capital.

I look forward to working with you in the coming Congress on these important issues.

With best wishes,

Sincerely yours,

TIMOTHY WIRTH, *Chairman.*

Representative NOWAK. Fine. Thank you very much. So, we do have outside interests that will await the total record when we are able to produce it and have it distributed.

We are going through this exercise, of course, in anticipation of whatever tax or other security law changes would be in order next year. So, we hope to have all of this completed in time for the beginning session.

At this time, let me call on Senator D'Amato for any questions or comments he may have.

Senator D'AMATO. Thank you very much, Mr. Chairman.

Commissioner Evans, in looking at some of the recommendations that have been made, it becomes obvious that many of them would take substantial recodification of the Internal Revenue Code. We talk about different treatment for small corporations, for example, income averaging, and that the accumulated earnings tax exemption be raised from its present level to $250,000. I am just taking a look at one area here.

I think many of these recommendations are good, particularly since they come from the people out there on the battlefield. But you know, Treasury is also going to have something to say with respect to those recommendations.

If we are going to attempt to bring about these changes, would you not suggest that Treasury be made part and parcel of this forum and that they also have these recommendations so that they can respond to them so that we can have them, on the record? How would you attempt to make your forum for next year even more productive?

Would you invite Treasury? Do you think that SEC should conduct this forum, or maybe should we have a shared kind of responsibility?

Mr. EVANS. The legislation sets up a format under which we are the host agency, if I might call it that, for the forum. However, it also required that we include representatives from other Government bodies, such as Treasury, the Federal Reserve Board, the Small Business Administration, and others.

The forum's report will now be made available to all of the agencies whose programs will be affected by the proposals.

In addition, I had understood that Treasury is going to be asked to comment with respect to the proposals that deal with tax matters. That is beyond our expertise and I would not feel competent to comment on such issues.

Senator D'AMATO. In other words, have you at this date submitted these recommendations to Treasury so that we could get their comment officially and on the record in regard to them?

Mr. EVANS. We only got the report finished yesterday.

Senator D'AMATO. OK.

Mr. EVANS. So the answer to that is, I don't know that we have sent the report to Treasury in that period of time. I suspect that we have not. I think we just transmitted it to you yesterday.

Senator D'AMATO. In other words, you will be awaiting their recommendations, though?

Mr. EVANS. I would expect them to respond to you, and I think you could well ask them to do so. The Commission is not in a good position to request the Treasury Department to tell us, as an independent agency, how they feel about some of these matters that are beyond our jurisdiction.

Senator D'AMATO. Of course, we have asked Mr. Chapeton to be here today and he could not, but I would suggest, Mr. Chairman, that as part of this committee's work, a very important ingredient would be to direct an inquiry to Treasury in regard to their review of this matter and how they find it, and let's get them on the record in regard to these recommendations.

Otherwise, I think much of the work of our committees will go for naught and I don't feel like undertaking the battle without getting them on paper, you know, I like to get them on paper and then we take it from there.

You know, I have had many of these negotiations into the wee hours of the morning as positions keep changing. But I would suggest, Chairman Evans, that you be a little more affirmative and direct and ask for a response.

We will ask for a response, but I think that you, who have been given the umbrella authority, so to speak, to conduct these forums should forward this report to Treasury and request a response. We will do the same thing.

Mr. EVANS. I think I could do that as chairman of the executive committee.

Senator D'AMATO. Correct.

Mr. EVANS. Probably not in the capacity of a Commissioner at the SEC.

Senator D'AMATO. I understand.

Mr. EVANS. That would be the way I would have to do it.

Senator D'AMATO. Fine. Second question, what would you suggest could possibly be done to make this forum more productive next year?

Mr. EVANS. There are a few things we probably could do. Let me state from the outset that the comments we got were almost entirely positive. People were very pleased with the way the Forum went, and I think our staff deserves a lot of credit for that. However, there are a few things we probably could as better.

Primarily, we would like to receive a greater number of small business people as a proportion of the total at the forum.

A number of business representatives commented that they were outnumbered by the technical people, the experts. I don't think any of them felt intimidated by that, and they indicated as much to me. However, some of them said that they wished there had been more small businessmen present. As I mentioned in my prepared comments, we did the best we could by inviting everyone that would come from a small business. Nevertheless, I think we can probably do a little better there after this year's experience, and we certainly will try to do that.

As far as the format of the forum, I don't think I would change it. It is probably the best format that I am aware of for getting input from people. Certainly, the executive committee was broad-based, including the government and private sector organizations that we determined would be interested. We let them determine the individuals who would come, so they had every opportunity to present whatever they would like. I think it was a good approach.

Senator D'AMATO. Thank you very much, Mr. Chairman.

Representative NOWAK. Thank you, Senator. We certainly do hope to get the record together in the very near future, and part of that record will be comments, both pro and con, with the arguments for and against by Treasury, referencing each and every one of the recommendations.

Thus we can look at the individual indepth comments as well as the total package, so that we can try to put together a format that will constitute a better kind of incentive package that could be combined with any new incentive that is developed here.

Chairman Mitchell, do you have any questions for Mr. Evans?

Representative MITCHELL. Yes; perhaps two. Throughout countless hours of hearings in this session of Congress, we have heard about the problem of access to capital. But concomitant with that, there has been a constant theme that for certain small businesses, particularly those associated with high technology or telecommunications, capital is available, that this is a growing field, and there is a lot of venture capital available.

To the best of your recollection, was this discussed at all during the forum? That is almost a dichotomy where you get a portion of the small business community crying, we cannot get anything, and

venture capitalists saying that if it is telecommunications, we will take the risk. Was that discussed?

Mr. EVANS. There are some what you might call pretty active areas in which venture capital is available. And there are those from venture capital firms who will say there is no lack of capital for reasonable types of projects, particularly in areas such as telecommunications. I suspect that may well be true. On the other hand, some firms want to obtain capital other than from a venture capitalist. Because they may not want the kind of input to decision-making that a venture capitalist often has.

Thus, in addition to funds from venture capitalists, it is important to be able to get capital from the public generally. To the extent that we could, we would try to make sure that such avenues are available.

Representative MITCHELL. All right. Then the other question, and perhaps this is a bit premature, there are a number of recommendations that were made about revising the Small Business Administration's programs to assist financing small business. Are you in a position to speak to those recommendations or should someone else do that.

Mr. EVANS. I think it would be better for me not to do that.

Representative MITCHELL. Not to do it.

Mr. EVANS. Yes; it would be more appropriate to let the SBA respond to those recommendations. I can speak for myself with respect to those that are under the jurisdiction of the SEC, but the Commission has not even focused on these, let alone formed an official position.

If you desire, I can give you some idea what I would expect from the Commission. We obviously, are willing to provide you with our views respecting all of the proposals dealing with securities matters after we have had a chance to look them over carefully.

You have a right to receive that. Some of the recommendations do not contain legislative proposals, but suggest that there should be administrative action on our part. I think it would be appropriate for us to give you an idea as to how we see those too.

Representative MITCHELL. Well, I indicated that perhaps my question was a little premature and we will just wait a while to hear from SBA and from you on those recommendations that fall under your bailiwick.

Thank you, Mr. Chairman.

Representative NOWAK. Thank you, Mr. Mitchell

Our next witness, by the way, will be Frank Swain, who is the chief counsel for SBA, and I think we can delve into that matter in a very short timeframe here.

I would like to introduce the ranking minority member on my subcommittee, who has also played a role and joined with me on many occasions in pursuing this question of capital formation. He has realized, I think, as many of us have, that unless more effort is put into this area, our total economy recovery will be much less effective.

I want to welcome him back again this year. I know that we are meeting for the first time since the election, and I suppose he is surprised to see me here too, Dan Marriott from the State of Utah.

OPENING STATEMENT OF HON. DAN MARRIOTT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF UTAH

Representative MARRIOTT. Thank you, Mr. Chairman. Mr. Evans, I am delighted to see these recommendations. However I look at them with a critical eye because 6 years ago I started my career at the end of the table, clear around there, and I worked my way up to this point. Back in those days, we had the administration coming up and telling us how wonderful it was to have capital formation in small business, and that they supported everything we stood for; then nothing ever happened.

I was led to believe that when the Republicans finally threw out the nasty Democrats in the last election, that there would be a Second Coming as far as capital formation for small business; that has not happened. We really are not much further ahead now than we were 6 years ago. So I am happy to see you endorse these types of things.

Specifically, we have been promoting for some time a participating loan program, and I introduced a bill to the chairman of the subcommittee. The bill basically said that we should encourage people to invest in small businesses by giving them some of the same goodies they might get if they invested in oil wells.

The participating loan idea is an idea whereby an investor could make an investment in a small business, take a 20-percent tax credit, get long-term capital gains on the back end, not have it construed as a security, and this and that and the other.

Is this something that the SEC could come up here and strongly endorse? Could you bang your shoe on the table and get the Ways and Means Committee off their duff and a few other things, and really promote this concept? Or, are we just dealing in generalities as far as these proposals are concerned?

Mr. EVANS. The securities proposals that are here in the report, were focused on by forum participants. Various other proposals that were before Congress at the time were also considered by the members of the forum.

As far as whether or not the specific investment you refer to would be construed as a security in which we have a regulatory interest depends a lot on the size of the issue, the number of people it was offered to, and a number of other factors that I would have to discuss in detail. Just to give a blanket statement that I would be willing to have an investment with which I am not familiar considered not a security, is not something I could do, nor do I think the Commission could do that. But if the proposal is within some exemptive guidelines which we think are reasonable—which, incidentally, are expanding—then I think you would find that we would respond in a positive manner.

Generally, we would not comment with respect to tax matters. We might tell you we thought it was a desirable thing for small business, but we are not experts in that area and it would probably not be appropriate for us to try to make that balance judgment.

Representative MARRIOTT. So, what do you see your role being, supposing that this subcommittee and then the full committee under Mr. Mitchell, decided that a participating venture of some type was really in the national interest, and so forth. We know we

have got Ways and Means Committee troubles to get past. What role would the SEC take in that? Do you pass-the-buck to Treasury, or do you see a role for yourself in promoting it?

Mr. EVANS. I think, depending on the outline of the proposal, we might be expected to come and give you our comments with respect to it. Where it was within our jurisdiction, I am sure we would be happy to give you comments.

Representative MARRIOTT. We do not want your comments, we want your promotion.

Mr. EVANS. I cannot tell you that in advance of seeing the proposal. I might like to do so, and you might like me to do so. Having come from Utah, both of us know that most of the businesses there are small businesses, but I cannot give you a response in advance of seeing the proposal and without having the Commission having focused on it.

Representative MARRIOTT. Well, that is why I asked whether or not the SEC is really in any position, in this regard, to really do anything constructive besides give us their opinions.

Mr. EVANS. We are in a position to deal with the securities matters that fall under our jurisdiction.

Representative MARRIOTT. To make recommendations to the administration along those lines.

Mr. EVANS. Yes, we are.

Representative MARRIOTT. I am very concerned about ERISA and also limited partnerships. Let me take the ERISA issue first.

What did your Commission conclude we ought to do with ERISA? Did they conclude that we ought to allow pension plans now to invest in small businesses of some type? What exactly did you conclude we ought to do with ERISA to make it more flexible?

Mr. EVANS. The forum did have some recommendations with respect to ERISA, with the goal of making it possible for pension plans to invest more in small businesses. There are a number of proposals that deal with that issue and I think you will find those very forward looking. So, while I would not want to give the final word on that, those are things that the forum participants thought were very important.

You asked what else we could do besides the securities matters. I feel that we have a responsibility to urge the other agencies and the Congress to consider these recommendations seriously. We do not think we have all the answers, but we do think that the group we had together was a responsible one. They were well-meaning people, who were not just trying to get a freebie from the Government. Admittedly, in some cases, as you might expect, they are strong advocates for their positions. But our view is that we would like full consideration to be given to all of these proposals, and we will try to insure that that occurs.

Representative MARRIOTT. One last question, and that is limited partnerships. Obviously they offer some creative financing for small businesses if they are used properly. Nowadays, though, to comply with the SEC regulations, you have to have an army of attorneys and pay $50,000 up front to raise $25,000.

What is happening in this area? Do you see the SEC relaxing their standards in that regard? I know we have to protect investors, but is there some way that you can come out with a simplified

approach that might allow small businesses to utilize a limited partnership in capital formation?

Mr. EVANS. As you probably know, partnerships are now permitted to use our form S–18, which is reviewed at the regional level and requests less information than previous registration forms used by small businesses. Earlier this year we removed the restrictions which prohibited the use of this cost saving form by issuers engaged in oil and gas operations and by noncorporate entities which would include, of course, limited partnerships.

We feel we have made a good step there. However, in all fairness I must tell you that we feel very strongly about investor protection. We feel that if we move too rapidly in helping to foster capital formation, we may well have a negative impact on investor protection, which is our primary responsibility.

Having just made this change last June, as I recall, I think we need to be a little careful not to move forward too rapidly. In other words, we have done something in the area, and if it works well, after having watched it a while, and we think we can move further, we will do that. Now I am not speaking for the Commission, you understand, but as an individual Commissioner. In any event, that is the direction in which we are moving.

Representative MARRIOTT. Well, I thank you, Commissioner. I think this is a step in the right direction, and certainly comes as good news to members of this committee and we hope that we can work with you and the other high priests of the Administration make something happen this year.

I appreciate your testimony.

Mr. EVANS. Thank you.

Representative MARRIOTT. Thank you, Mr. Chairman.

Representative NOWAK. Thank you very much, Mr. Marriott.

We have with us also from the full committee, someone who has been interested in this area for a considerable amount of time and has cooperated with us, the Hon. Ed Weber from Ohio.

Representative WEBER of Ohio. Thank you, Mr. Chairman. I am very anxious to hear the other members of the panel, but I do have just a few questions.

Commissioner, could you turn to your testimony where you list the eight subject areas into which your recommendations are following, and which among these recommendations had the most support, if you can recall?

Mr. EVANS. The most support within the Forum?

Representative WEBER of Ohio. Yes.

Mr. EVANS. Well, you realize these are just general topics of concern. There are a number of specific proposals under each of these areas.

Representative WEBER of Ohio. Well, is it possible to say which of these areas, then, seem to be the area of greatest concern?

Mr. EVANS. I don't know that I can answer that for you.

Representative WEBER of Ohio. OK.

Mr. EVANS. I can say that all of the proposals in the report have at least a majority vote.

Representative WEBER of Ohio. OK.

Mr. EVANS. All of them have a majority vote; some of them were virtually unanimous. I do not remember the actual figures. If you

would like, we can certainly try to provide that for you if we have those figures available.

Representative WEBER of Ohio. I think that is something that we can keep in mind for the other members of the panel, then. I do not have any further questions.

Representative NOWAK. I think Mr. Weber's question is a good one, to see the type of support within the forum for each of the proposals. Were those records kept as to vote or any objections to any of the recommendations?

Mr. EVANS. We have an actual transcript of the Saturday session which includes the votes, and I believe that in many cases we will have the actual numbers within that transcript. Where it was very, very lopsided, we probably would not have a number because we did not count them. Any time it was close, we counted them, and above that, you could assume that two-thirds or so, an obvious majority, was in favor of them, and that is about the best we can do.

Representative NOWAK. OK. I wonder if we could leave the record open and you can bring the information you have to the committee to be included as part of the record. The final report on the "SEC Government-Business Forum on Small Business Capital Formation" is hereby submitted, and we will leave the record open, so we can list the recorded votes that you do have, and express the unanimous approval of all the others that perhaps are not so noted.

[See appendix for the "SEC Government-Business Forum on Small Business Capital Formation final report."]

Mr. EVANS. Could I, on behalf of the forum, the executive committee, and the members that attended, thank you very much for holding this hearing. There is nothing quite like going through a lot of work and then having it just disappear. As you have mentioned, it often does.

We hope that with our efforts and with your efforts that these recommendations will not just disappear, that there will be something meaningful coming out of this forum. The results, I think, will have a major impact on how well we do in our forum next year. If people find that this is meaningful, they will be willing, I think, to spend their time and their efforts to try to enhance its meaning.

Representative NOWAK. Well, I am sure you know, this committee has been interested in the subject for a long time and we do try to seek as broad opinion as we can. I think one of the very best ways to do that is to get diverse opinions out of forums such as this. I think the White House Conference did crystalize some areas that were picked up in the 1981 Tax Act. Although we did not go as far as perhaps many of us would have liked, at least the recommendations were considered, and I think parts of many were adopted.

As we get more information from Treasury, working as closely as we are now able to do with the Senate because of Senator D'Amato, we will jointly work on these recommendations so that we can start on both sides of the spectrum and get a consensus that will move through the House without the usual tremendous referral process that bogs everything down.

We appreciate the sincerity and the commitment of the SEC on holding this and doing the type of professional job that I believe was accomplished. We do think the recommendations are meaningful and look forward to working with you on some of the detail.

Thank you very much.

Mr. EVANS. Thank you very much.

Representative NOWAK. Our next witness will be the chief counsel for Advocacy for SBA, Mr. Frank Swain. He is from New York, Senator D'Amato.

Senator D'AMATO. Syracuse.

Representative NOWAK. Corning, outside of Corning Glassworks, I think.

Senator D'AMATO. Well, he came up and told me he was from Syracuse, that is why we confirmed him.

Representative NOWAK. He just wanted a bigger city to impress you, I think. [Laughter.]

Mr. SWAIN. Upstate is all the same; Senator, you know that.

Senator D'AMATO. Right.

Representative NOWAK. Mr. Swain did graduate from Colgate University and Georgetown University Law Center. Previously he practiced law in New York State and was formerly the legislative counsel for NFIB, the National Federation of Independent Businesses, so he comes here well qualified on this subject.

TESTIMONY OF FRANK S. SWAIN, CHIEF COUNSEL, OFFICE OF ADVOCACY, SMALL BUSINESS ADMINISTRATION

Mr. SWAIN. Thank you very much, Mr. Chairman, and Senator, I can state that in my experience of working on small business issues here in Washington, this is the first time to my recollection in at least 3 or 4 years that there has been a joint hearing of the two respective small business committees and I consider that in itself a very positive step.

I think that it is important that the Small Business Committees continue to devote considerable amount of attention to small business issues that are not necessarily wrapped up in SBA programs.

I think that sometimes the public thinks that the Small Business Committees simply pass judgment on the SBA programs, where, in fact, they play a very important role of raising issues and informing the record on a number of other important policy issues.

It was my pleasure to serve on the executive committee of the "SEC Small Business Forum" and it is in that context that I am here to comment and take your inquiries, and of course, at the outset, I want to emphasize that my recommendations do not necessarily reflect the views of the SBA or the administration, and I am not in the position to make any legislative recommendations on their behalf.

As I am sure the committee is aware, many of the items being discussed today are of concern to other agencies and as the committees usually do, I am confident that their views will be solicited. It is a long way of saying that I am not here as a high priest of the administration today, but here as somebody who has been informed about the conference through my participation and through my continuing work with small business.

I wanted to comment on a number of the proposals that were recommended by the conference and because of the timeframe and the other witnesses, I would request that my statement be received in the record and will try to summarize it as best I can.

Representative NOWAK. Without objection, so ordered.

Mr. SWAIN. I think the point that Chairman Mitchell made a few minutes ago on the difference between those sorts of recommendations that are related to venture capital-type issues and other types of recommendations that might have a broader interest in the sense of more routine business types is an important distinction. When you are looking at the access of small businesses to capital, just by solving venture capital problems, you are not solving the problems of the community as a whole, and vice versa that just by making some modest tax changes, you are not solving everybody's problems either.

Nonetheless, I think the meeting did a very good job in trying to sort through the most important things in a number of different fields. I think in the tax area, of particular significance was the recommendation that the general jobs tax credit be reinstituted. As the committee is no doubt aware, there was a general jobs tax credit for 2 years, in 1977 and 1978. It was available to any business; it was available for hiring any net new worker. It failed miserably. I think it failed miserably primarily because the Carter administration's Treasury Department was not very enthusiastic about it and because it did not receive very good publicity.

Nonetheless, I think as a vehicle that is open to any small business, regardless of its type, and regardless of the type of worker that it specifically needs, it is probably the tax vehicle that is most suited to encourage small businesses to accelerate their hiring of new workers. Of course, the SEC forum discussed the issue at length. I think that certainly in a time where we are experiencing some very difficult unemployment problems, it is probably a very apt recommendation that the Congress devote itself to further study of this issue.

On one of the other major issues that it looked at in detail was ERISA requirements. I would like to comment particularly on a very important, yet somewhat technical regulation called the plan asset regulation, which has the potential of, I think, freeing up much greater pension plan investment into small business. As you know, there are a number of technical regulations that apply to that now. The Labor Department has had this subject under review for the past 3 years, and I think they are about to come out with a recommendation.

Needless to say, the small business community, as well as our office, will be awaiting their recommendation, hoping that the recommendation will not overly tighten up any regulations that are in effect now, but expand the opportunities for pension fund managers to make responsible investments in small businesses without running afoul of some of the various regulations that are already on the books. I think the potential for pension fund investing in venture pools is significant. In 1981, it was estimated that $200 million of pension fund investing went into venture pools. It is estimated that for the first half of 1982, there was $228 million.

So, I would expect that it would be about twice the amount that there was in 1981. Clearly, this is a largely untapped source of funds for small firms and I think that the role of the Federal Government in regulating the types of investments that can be made is a very important role that needs to be closely scrutinized when the final regulations are proposed by the Department of Labor.

Another area in which the Congress is really not the player but the agencies are the players is in the area of securities regulation. Of course, in the tax area, as your questioning of Commissioner Evans indicated, it is really, in most cases, the responsibility of Congress to make legal changes. But in a number of areas, and specifically in the securities regulation area, the SEC and in some cases other agencies, can go ahead and make some changes without necessarily waiting for congressional action.

I must say that the SEC has been very good, I think, in reviewing a number of the regulations that are already on the books, trying to simplify them and condense them where possible. Certainly, their regulations issued earlier this year in regard to the reporting requirements on regulation D, as well as the adoption of form S–18, indicate that the Commission is interested in going in the right direction.

I think that it is important that the Congress put in 96–477, the Small Business Investment Incentive Act of 1980, the title that requires the Commission to do this. Historically, the Commission regarded as its first and sometimes exclusive task the protection of the investor and the protection of the financial marketplace.

That is certainly accurate. The question is how much do they have to weigh in making their regulatory decisions, the impact of those decisions on the flow of capital to business and on the flow of capital to small business.

The statutory provision in the Small Business Investment Incentives Act of 1980 started the process by which that is brought to their attention. I think that it is absolutely relevant that in deciding how much disclosure is necessary, they also take into account the strictness of the disclosure requirements and their effect on capital investments.

For instance, for the S–18 registration statement, the SEC Conference suggested that the threshold be raised from $5 million to $10 million. We had previously suggested that not only this be done, but a previous study commissioned by our office indicated that the relative number of investors which might lose a measure of protection from the SEC reporting requirements was far outweighed by the relatively great number of companies that might have new access to the capital market and therefore perhaps certain small public issues should be exempt from reporting costs.

In other words, the Commission overall, I think, needs to take more into consideration on the capital access side than they have traditionally been doing. I think they have started in that direction, I would encourage them to continue further.

Another very important area, which I think is really within the purview of many of the States, is the issue of uniform State-Federal regulation. Admittedly, we are in an era where we are recognizing that many times a local decision is the proper decision, but certainly you Representatives from New York State can attest to the

fact that a State that has a less restrictive securities registration requirement reaps the benefits in terms of commerce and trade of securities within that State.

In fact, there are a number of States in which it is very difficult and expensive to register securities, and I think that the fact that there are 51 jurisdictions with 51 different regulations has a particularly onerous burden on the smaller registrant, or the $100,000 or $200,000 or $500,000 issue, in which some close decisions have to be made on where they can afford to pay the lawyers to go through the blue sky laws. I think that the Congress and the State securities commissioners should redouble their efforts to try to make some modifications to obtain a greater degree of Federal-State uniformity.

Certainly, the SEC has been over some of these threshold issues very carefully indeed and I think it would be heartening to the small business community to see more of the States adopt some of the SEC standards that they have recently examined.

I would like to express one final issue which I think is particularly important and which I know that both members of this House subcommittee, as well as the Senator, are particularly interested in, and that is the debt-equity issue. I have had small business people tell me that the potential confusion that might arise because of the debt-equity regulations that have been previously proposed would be the OSHA of the 1980's as far as small business is concerned. I am sure that is a bit of an overstatement, but technical, tax, securities, and legal people are the only ones that are really in a position to figure out how much of an overstatement it is.

In our testimony, we tried to synopsize the debt/equity regulation chronology and ended up spending 15 lines discussing when various proposals were made and then withdrawn and then remade. Of course, the administration is suggesting that before the end of this year, or shortly into 1983, they will again make a proposal on debt-equity. I hope that it is a proposal that is simple and that provides adequate safe harbors for investment, particularly hybrid type investments made in small business.

Because if it is not, then we are going to run the risk of choking off a lot of productive investment in small business for the sake of, I think, some technical precision in the Internal Revenue regulations.

Finally, I think that the Commission is to be commended in general for its approach to this conference and I, certainly, hope that they will continue the conference again next year. Our only suggestions would be that the planning process is started a bit earlier so that we can make it even better than next year, and I would echo Commissioner Evans' suggestion that more be done to attempt to get more real small business people to the conference so it is less a discussion among legal and accounting experts, and more a discussion of the general problems of the small business community.

I think that the conference was an excellent start, both in raising the issues involved and also in reminding the Commission, of this important side of their securities regulation, that is, the effect on small firms to capital access.

I would be happy to try to respond to any questions that you may have.

[Mr. Swain's prepared statement follows:]

PREPARED STATEMENT OF FRANK S. SWAIN, CHIEF COUNSEL, OFFICE OF ADVOCACY, SMALL BUSINESS ADMINISTRATION

Mr. Chairman, I appreciate your inviting me to participate in this very important hearing concerning the Securities and Exchange Commission's (SEC or Commission) Government-Business Forum on Small Business Capital Formation (Forum) which was held in Washington, D.C. September 23–25, 1982.

As you know, this conference was sponsored by the SEC to fulfill a legislative mandate to hold an annual forum on behalf of small business as stipulated under Title III of Public Law 96–477, the "Small Business Investment Incentive Act of 1980." In addition, the Commission is required to (1) coordinate such activities among federal and state governments and private industry; (2) cooperate with "any association composed of duly constituted representatives of state governments" who are in charge of state securities laws; and (3) use its best efforts to identify and reduce the cost of raising capital for businesses whose outstanding securities and other indebtedness have a market value of $25 million or less.

Mr. Chairman, I was honored to have been part of the Executive Committee whose task it was to plan for this first forum. The members of the executive committee were high caliber professionals within the financial community and within Government. Even though the time frame was short in terms of developing the issues and handling the logistics of the conference, an extremely fine effort was made to assure that the legislative intent was served.

The Office of Advocacy played an important role in helping to develop this first Forum and in assisting in the preparation of some of the vital issue papers presented to the Forum participants. I am especially pleased to report our active participation since the House Small Business Committee serves as our Oversight Committee. Of all the issues that constantly plague small business' survival, the lack of adequate access to capital and credit at affordable costs continues to rank number one.

In my testimony I would like to provide some thoughts concernings certain key recommendations of the Forum and then offer some suggestions for next year's conference.

Since there are some 39 recommendations adopted by the Forum participants, it would be difficult to adequately assess and provide commentary on each of the proposals. Rather, I would prefer to provide some public policy viewpoints with respect to those recommendations which relate to some of the issues which the Advocacy office has been addressing.

JOBS TAX CREDIT

On September 20, 1982, I presented a paper at the American Institute of Certified Public Accountants (AICPAs) 1982 Small Business Tax Equity Conference. I believe the paper serves as "food for thought" and action during these times of significant unemployment.

In brief, the paper proposes a jobs tax credit that will redress the bias of the existing tax structure against labor intensive businesses and in favor of those which are capital intensive. The credit is structured to provide additional incentives for an employer to hire unskilled or marginally productive workers, including teenagers who have found it hard to break into the workforce. The employee would learn marketable skills and gain initial experience in a given work environment. The credit would bridge the gap between the current marginal worth of a non-skilled employee with potential as contrasted with a productive employee having an extensive experience base. There is a reduction of the credit after the first 12 months to reflect the enhanced experienced base between the marginally hired and the employee representing the productive norm. During the second and third 12 months of the employment cycle it is assumed the employee would acquire additional technical skills thereby becoming generally more marketable in his/her field of work.

The formula is based on the actual work cycle and earnings of individuals while the credit flow to the employers will have specific obligations to the specific employees hired who earn jobs tax credits. The credit covers a twenty-four month cycle of wages for each "designated" employee, at 30 percent for the first twelve months up to a maximum of $584 base per month or $7,000 per annum per designated employee and 15 percent for the next twelve months for each such designated employee. Thus, if 5 new "designated" employees with potential were hired utilizing this

credit, the employer could receive a maximum credit amount of $10,500 (5 x $7,000 x 30%) during their first 12 months of employment. The second 12 months could bring up to $5,250 (5 x $7,000 x 15%) for those "designated" employees hired in year one, plus additional credits for any new "designated" employees hired in year two. I would be pleased to introduce this jobs tax paper into the official record of these hearings.

RELAXING ERISA REQUIREMENTS

As Chairman of a Subcommittee on Regulatory Disincentives of the Interagency Council on Minority Business Enterprise, I have had an opportunity to review some of the major problems of adversely impacting the flow of capital to small firms including firms owned and managed by socially or/and economically disadvantaged persons.

It was determined that one of the most relevant regulatory impediments to the flow of long-term funds to firms with growth potential was the "plan asset" regulation. This regulation has been under review for the last three years by the Department of Labor (DOL) under its ERISA statutory obligations. The importance of this regulation to the venture capital community can be illustrated by the fact that one of the single largest dollar source of venture capital money in the United States is derived from pension funds. Approximately $200 million of pension fund investing in venture pools occurred during 1981. For the first half of calendar 1982, pension fund venture investment increased to $228 million and represented 32 percent of all venture capital raised for that period. It is estimated that from 1978 to the present, pension funds have contributed approximately $710 million to the venture development process, or less than one tenth of one percent of total pension fund assets. Even this relatively small amount has been a very significant source of equity financing for growth firms.

The uncertainty that continues to prevail because of the lack of a realistic and workable regulation has caused serious delay for those professional and experienced venture managers who are trying to raise capital to invest productively in reviving our nation's economy. We believe, the DOL should adopt a definition of the term "plan assets" to permit professional venture capital managers to invest pension plan funds without qualifying as plan fiduciaries and without venture pool assets qualifying as plan assets. Public policy must protect the benefits accruing to and expected by the ultimate beneficiaries. It is my belief that the investment returns on the relatively minimal amount of pension in funds at risk which can be achieved by experienced venture capital managers may be significantly higher than historic returns of traditional pension investment portfolios. Thus, such select managed risk investing can contribute to an increased investment return for the overall portfolio of pension assets and expands the economic benefits to plan participants.

We understand that the DOL will be ready to publish a revised "plan asset" regulation in early 1983. Our office and the small business community look forward to helping the DOL work towards a speedy resolution of this important problem.

REDUCING COSTS ASSOCIATED WITH SECURITIES REGULATIONS

The Office of Advocacy has for several years been working diligently to assist in efforts to reduce the costs of compliance with federal and state securities laws.

We have encouraged the SEC to (1) establish a uniform exemption scheme for "private placements" as exemplified by the recently adopted Regulation D;[1] (2) to provider greater certainty to the definition of "accredited investor" or those investors who are able to fend for themselves and have no need for the disclosure protection of the securities laws; (3) increase the ceiling limitation from $5 million to $10 million for SEC Registration Statement on Form S–18 which is a reduced disclosure document for small firms (this was also a recommendation of the Forum); and (4) increase the threshold for registering and reporting firms under the securities laws from $3 million in assets and 500 shareholders to $10–15 million in assets/revenues.[2]

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[1] Regulation D was made effective by the SEC as of April 15, 1982.

[2] A study by A. E. Osborne and Associates, commissioned by the Office of Advocacy, indicates a correlation between the number of shareholders, and asset and revenue size of businesses and number of employees. Consequently, by adjusting the reporting system to provide relief to small businesses, a relatively small percentage of shareholders, compared to the percentage of firms whose reporting obligations are reduced, may be adversely affected by reducing the information available.

The SEC Forum recommendations address many of the aforementioned securities issues. I should like to comment further on the additional securities issues that are of concern to me as developed by the Forum attendees.

The Forum's recommendation that the Commission introduce the concept of "substantial good faith compliance in all material respects" into their exemptive schemes appears to be worth further study with regard to the impact of such a concept in reducing indirect costs of compliance for small issuers. As I understand it, this concept would be utilized only where an inadvertent technical error with the Commission's exemptive requirements had occurred but there exists "substantial good faith compliance in all material respects." The anti-fraud provisions of the Securities laws would remain unaltered. The legal and "due diligence" costs associated with exempt offerings have never been quantified. If it can be determined that the costs associated with an inadvertent technical error are disproportionate to total cost of an offering and to the intent of Securities law public policy, the recommendation of the Forum should be given serious consideration.

Regulation D, was recently promulgated by the SEC to blend the overlapping reporting and disclosure obligations of three prior distinct, predecessor regulations dealing with "private" offerings. We believe care should be taken that the small business regulatory relief obtained under Regulation D should not be diluted by the SEC's interpretive process so that use of Regulation D reverts back to the cumbersome and costly procedures of the predecessor regulations.

In addition, consideration should be given to distinguishing in the Commission's regulatory, interpretive and enforcement processes the differences between "tax shelter" private offerings under Regulation D and those offerings where the proceeds are used for the growth, expansion, and modernization of a "small" manufacturing or service enterprise. The flow of funds used for the growth and modernization of small firms must be unhindered and given a national priority. In this regard, the enforcement problems associated with "tax sheltered" investments should not necessarily be attributed to *all* offerings of small issuers.

UNIFORM FEDERAL-STATE SECURITIES REGULATION

In the context of distinguishing between "tax shelter" securities and exemptive securities that are sold by small issuers to raise capital for growth, expansion and modernization of their businesses, a very important recommendation of the Forum deals with uniform Federal and state securities regulation. We are aware of the public protection concerns of state securities administrators when reviewing a potentially fraudulent and/or misleading prospectus, especially when the dollar amounts being raised are of significant proportions. However, we believe that it is in the public interest to avoid duplicative, time consuming and costly reviews by several governmental agencies. Fifty-one different jurisdictions each with their own particular requirements makes it extremely frustrating and costly for a small business issuer to raise capital in a timely manner.

While respecting the rights of the states to establish their own individual standards, we urge that where a Regulation D private offering exemption is involved, those Federal standards should be adopted by each of the states so that whether the issue is made under Rule 504, 505 or 506 of Regulation D, a single exemptive test will apply. This is especially crucial in the area of the standards of investor "suitability" requirements, the definition of a sophisticated or "accredited investor" and the application of disclosure requirements to specific "purchasers" rather than general "offerees." Again, we suggest that if "tax shelter" offerings are distinguished within these standards, the concerns of the state securities administrator will be substantially eliminated.

DEBT VS. DEFINITIONS UNDER IRS REQUIREMENTS

Another area of very special interest to our office over the last several years has been the Section 385 or "Debt/Equity" regulations proposed by the Internal Revenue Service (IRS) in 1980.[3] We understand the intent of these regulations was to

[3] The Section 385 regulations were issued in proposed form on Mar. 20, 1980, 11 years after the enactment of Section 385. They were promulgated in final form on Dec. 29, 1980, with a delayed effective date of May 1, 1981, which was further extended to Jan. 1, 1982. On Jan. 5, 1982, after indicating earlier it would not hold to the Jan. 1, 1982 effective date, the Treasury Department published proposed amendments to the final regulations which were to be effective July 1, 1982. As a result of substantial small business and legislative pressure, the Treasury Department, on June 23, 1982, again extended the effective date, this time to ninety days after issuance in final form but in no event earlier than Jan. 1, 1983. A week later, the Treasury agreed to delay until Apr. 1, 1983, the effective date of the final regulations.

achieve greater certainty to the definitions of what constitutes "debt" or "equity," for purposes of the tax treatment of financial instruments on the balance sheets of business concerns. We have presented oral and written commentary to the IRS on the impact these regulations can have on the small business community and on the venture capital investor who oftentimes utilizes a "hybrid" security (combination of debt and equity) to make risk investments in startup situations. While the IRS has made substantial beneficial changes from the initial regulation to meet these concerns, clear "safe harbors" for small businesses should be structured in the final regulations issued by the IRS. Such definitions should be realistic in terms of the way new and young small firms finance their operations (especially startup firms), and the way venture deals are required to be structured to meet the individual financing problems of growing firms.

CHANGING FINANCIAL SERVICES INDUSTRY

From a broader perspective, the attendees of the SEC Forum expressed their view that any legislation in connection with the financial industry should consider the needs of small and medium-sized banks which finance small businesses.

As you know, Mr. Chairman, our concern in this area was presented to your committee in a hearing you held on May 19, 1982. Since that time, dynamic changes affecting all financial institutions have been taking place at an accelerating pace. We have provided direct commentary to various Federal agencies, including the SEC, FDIC, DIDC, and others, indicating the long-term benefits that can accrue for the financial industry from the deregulation process, but strongly urging careful review of the short-term impact such changes could have on the survival of small local financial institutions that have historically provided the bulk of credit and capital to community businesses.

The Garn-St Germain Depository Institutions Act of 1982, addresses the need to support the small local financial institutions to some extent. We trust the regulations and procedures which are adopted pursuant to such Act will permit small firms to access local sources of credit at competitive and affordable cost of capital rates. To this end we hope the competition for various savings and investment instruments will create more funds available for lending purposes rather than cause an outflow of capital from the non-major financial centers of our country.

The Office of Advocacy has prime monitoring responsibility for the implementation of the Regulatory Flexibility Act (RFA). The fundamental goal of the RFA is to insure that federal regulation is imposed on small entities only to the degree necessary to meet the statutory requirements of substantive legislation. The RFA requires federal agencies to integrate small business and small entity thinking into all of its regulatory planning, to actively seek out data and opinion, to understand small business impacts and to incorporate this data into the developmental stages of their rulemaking activities. The Office of Advocacy intends to closely monitor the changes occurring in the financial services industry and the federal agencies involved with those changes. We will pay particular interest to the impact on the small and medium-sized members of the financial services industry and the local small business clientele they serve.

In addition to the issues set forth above with which the Office of Advocacy has been directly involved, we believe a small business investment credit and a capital gain rollover for small business investments would be helpful to small business capital formation. An investment credit of some type for investment in a small business would stimulate the flow of funds to small businesses by providing a clear and direct tax incentive for such investments. Additionally, as a tax credit, it encourages investment by taxpayers at all income levels.

A capital gain rollover provision would also encourage the flow of investment capital to small businesses. It would also increase the incentive to retain investment capital in the small business sector. Such a provision also ameliorates the incentive created by the reorganization provisions of the Internal Revenue Code for the further concentration of business into large units. Essentially, this type of provision would serve to reduce the tendency of small business owners to dispose of their businesses to large corporations with publicly traded securities in order to avoid immediate taxation. Under this provision, a small business person can sell his interest in one business and reinvest in another without incurring immediate taxation. This is the same advantage he would get if he exchanged his small business for stock in a large corporation. Thus, the rollover can assist in providing small business continuity.

SMALL BUSINESS DATA BASE

In connection with the Forum's recommendation that a small business data base be developed so that the effects of proposed tax changes on small business can be more accurately determined, the Office of Advocacy has a legislative mandate to create such a data base for small business. We are currently working with the IRS, under an agreement established last year, to begin to draw on IRS data to give us more specific information on small corporations, partnerships, and sole proprietorships. Inasmuch as the IRS must assure confidentiality of data for individual returns, we are working towards using microdata from the Statistics of Income samples and aggregating the results based on small business criteria, without having direct access to individually indentifiable records. This procedure will maintain the confidentiality rules under which the IRS must operate.

THE 1983 FORUM FOR SMALL BUSINESS

Finally, I believe there are areas of improvement that can be made for next year's forum.

With a longer lead time, I believe that a better effort needs to be made to attract a greater number of diversified small firms. In this connection, there should also be more effective communication during the Forum between those who are technically skilled in the legal and business problems of financing basically large businesses and those owners and managers of small firms who must live with such problems on a different scale and with a different impact. The Forum should reflect the problems of small firms as those firms see them. The practitioners should translate these problems into direct, simple technical solutions.

A formalized followup mechanism should be developed which indicates where and to whom the recommendation of the Forum have been sent with periodic meetings to monitor the development of the proposals and provide a status report at next year's meeting.

Consideration should be given to holding the 1983 Forum in a geographic area outside of Washington, D.C.

The Forum format should be structured to provide the development of issues on legislative amendments, regulatory/administrative changes, private sector initiatives and anticipated problems of the future.

Thank you for inviting me to participate in this very important hearing.

Representative NOWAK. Thank you very much, Mr. Swain. We, I think, are in agreement about this jobs tax credit, although many have said it did not produce what they had hoped in the late 1970's. Certainly it should help when you combine the jobs tax credit with some training. What we are seeing more and more of, of course, is people being dislocated, such as the auto worker, the steelworker, and others, unable to continue in manufacturing types of business, looking for some other type of work. I think a jobs tax credit would provide some incentive for new employers to hire those persons and perhaps to spend some money on training funds for them. Making that transition and putting an active participant back in the economy would be money well spent, and with more publicity and with generally less paperwork, I believe that that could be a terrific incentive to start to reduce those unemployment numbers that everybody is alarmed about.

Recently, there was a somewhat disturbing study regarding jobs creation by smaller firms by the Brookings Institute and that study somewhat contradicts the widely quoted David Birch study which had statistically up to almost 80 percent of the "new" jobs in America being created by the small business community.

I wonder if you have had time to look at that and have any general comment on that.

Mr. SWAIN. We have indeed had time to look at that because we funded the Brookings study and we are funding the Birch study, so

we are in the either happy or unhappy position of seeking the truth wherever it may lead us.

Senator D'AMATO. See what happens when you fund those studies? You undercut your own advocacy.

Mr. SWAIN. The appropriations process may have.

Senator D'AMATO. You might have hired a couple of interns, maybe, and done it in-house. That is what you call a controlled study.

Mr. SWAIN. A couple things that I think are sometimes lost in the general conversation. First of all, the article in the Washington Post, which I am sure appeared in other papers, looked at that, I think, from really the glass-half-empty position. The Post article started out by saying that small businesses wanted something special and therefore they went trumpeting this job creation data, which, although the reporter did not say it was bad, he said it did not look very good to him.

In fact, I do not believe that small businesses want anything special, but I think what they do want is a fair and equal chance. Sometimes to get a fair and equal chance, you have to look at the ways that they have not had a fair and equal chance, given the set of laws and regulations that have arisen over the past several years.

Certainly one measure of small business' contribution is job creation. The fact is that Mr. Birch and the Brookings study looked at two different time spans within the economy. The Birch study was 1969 through 1976, the Brookings study was 1977 through 1980. The Brookings study measured, I think, a much less vigorous period in the economy, per se, than the Birch study did. Second, they looked at the numbers in a different fashion.

Senator D'AMATO. Frank, did not Birch come out with something like 90 percent of all the new jobs are created as a result of small business?

Mr. SWAIN. I think the figures were 83 or 87 percent.

Senator D'AMATO. Quite a disparity, though, is that not true?

Mr. SWAIN. I think that when we have some further studies in, we are going to come up in the middle, we are not going to be——

Senator D'AMATO. We are going to hire a third group now? What group is that?

Mr. SWAIN. Someone suggested that asking for more studies in Washington is like asking a puppy whether it wants its stomach rubbed. I do not know how we are going to resolve this information difference, and I am not sure that it is really that important because even the Brookings study has some very good things to say about the special talents the small businesses have in creating jobs in economically depressed areas where large businesses clearly do not have a good track record.

I think the dispute raised by the Birch study and the Brookings study has only been discussed for a couple months and other statistical experts will continue to look at these issues.

The fact that people are even asking this question, I think, is a good one because people are realizing that small business does make a contribution. Brookings is the most conservative possible methodology and I think Birch is the most liberal possible methodology and the truth is probably somewhere between the two. I don't

think pinning down the final exact figure will be that significant. The fact remains that small business contributes to the economy in greater proportion than most people realize and I think that it deserves more policymaking attention than it usually gets.

Representative NOWAK. Thank you very much. I would hope that there is some effort to resolve that. I also believe if you are looking at the Northeast, you are going to come much closer to the Birch statistics than the Brookings study would have led one to believe.

The main fact is you still have 40 percent of the work force, even declared in that article in the small business community and it is significant that legislation that runs through here, and even the 1981 act, did not measure any benefit in any portion of 40 to 60 when we looked at the results of that act.

Let me see if Senator D'Amato has any other comments.

Senator D'AMATO. Frank, I am wondering if you have any figures on the targeted job tax credit, the effect that passage of that legislation had in terms of numbers of employees who are hired?

Mr. SWAIN. I do not have them at the tip of my tongue, Senator. I believe there are some figures and I will try to get them to you.

Senator D'AMATO. I think it is important to note that even though that bill was limited to minority groups, handicapped, et cetera, and that there were rather severe limitations placed upon it, I think the first $3,000, or 10 percent of that $3,000 in salary, the employer could take a credit and that credit would be for only 2 years, so it did have quite a beneficial impact and we should not so quickly just dismiss it, rather we should look to enhance it.

It seems to me, Congressman, it might be a vehicle which would be pretty difficult for this administration, and any other administration, to turn down. It uses the old principle of taking those who have very special problems, recognizing these problems, building and enhancing on that and I think that this provides an excellent opportunity to expand our efforts in that area.

I think we can keep it to minimal cost so that we do not run the old battle of Treasury saying that we cannot afford this kind of job creation. Of course, I submit that if we were to recalculate the job flowback, the dollars that are produced at the State, local, and Federal levels as a result of the creation of those jobs, many of which would have never come about otherwise, that it is indeed a revenue enhancer, particularly since you are taking many people off the welfare rolls and the unemployment rolls. I would be interested in those figures if you could develop them for us.

Mr. SWAIN. We certainly will try. I could not agree more, and I think that the opinion expressed at the SEC conference on this issue is not that the targeted credit should be abandoned, but that it should, in fact, be supplemented by a more general credit.

And if, in fact, the targeted credit were to be worth, say, twice as much so that there was a continuing incentive to hire members of the target group, that is just fine. We are in a very special time of unemployment where perhaps a greater incentive at the margin might be more important now than it would be when the economy is doing better.

Senator D'AMATO. Thank you very much.

Representative NOWAK. Mr. Marriott.

Representative MARRIOTT. Thank you, Mr. Chairman. Frank, it is good to see you again.

Mr. SWAIN. Thank you, Congressman.

Representative MARRIOTT. Always nice to have you before the committee. With all these great recommendations here, I can kind of see us jumping around next year like a one-legged frog on a frozen freeway, trying to put our finger on one of these proposals.

Which of these many proposals do you think is the most likely to get going, and as the advocate, which can you start advocating first? Do you have a preference here or something that you think that we can get going on that appeals to you?

Mr. SWAIN. I think that that is an interesting analogy, I could not have said it better, Congressman. I think the tax area is an area that clearly is probably going to be considered again by the Congress this next year.

Certainly it is under active consideration within the Treasury Department and within the White House. As you well know, every time there is a tax bill, it starts out targeted on one or two specific issues; and by the time the Finance Committee and the Ways and Means Committee finish their conference, it is "Katy, bar the doors," the number of various things that find their way into it.

I think that in the past year, this committee has been particularly influential in making sure that Ways and Means Committee did address itself to some important small business issues such as the inventory counting issue and the estate tax issue. I would certainly commend to the committee's attention all of the recommendations in the tax area and suggest that you devote some time and study and perhaps at an appropriate time, intercede with the Ways and Means members.

I can say that from my own experience, both inside the Government and outside the Government, the simpler the proposal, the better. So if you have a simple proposal such as small business rollover or the holding period for small business investments, the increase in section 1244 stock, a fairly simple idea that can be seen to create a real benefit, rather than creating a brandnew structure, then I think that is probably more likely to be accepted.

If you would like, we would certainly try to work with the committee to try to narrow down and prioritize some of these things so that we can concentrate on what seems to be the most doable.

Representative MARRIOTT. I think that would be a good idea, you know; almost everything that is going to benefit small business is going to have something to do with taxes. We got off on this cutting-taxes kick, as you recall, and everybody was for cutting taxes and now we are the ones for increasing taxes. The question is, with that spirit of increasing taxes, can we realistically get any kind of a tax program through which has to do with lessening the tax burden or providing tax credits for small business?

No sense in us wasting our time if there is no hope at all in getting any of that type of thing through Ways and Means. We ought to go off and address some other nontax issue.

I would hope that this committee and your Department there could maybe work together this year and try to identify what are the most likely areas of passage, prioritize those, and then start at that level and see if we cannot get something done.

Mr. SWAIN. We will certainly try to do that.

Representative MARRIOTT. We would certainly appreciate you giving us a list of your priorities in that regard.

Mr. SWAIN. I should say that I was very interested in seeing what this conference recommended because I do not think that I have a crystal ball any more than anyone else does about what the Congress is going to be in the mood to do on taxes this year.

Clearly the statement of this seminar, of this conference, that came straight out of the small business community that these were their key tax areas that they are interested in, I think, should carry a lot of weight.

Representative MARRIOTT. Since most small businesses are proprietors or partners, and would benefit more from a reduction in personal income taxes and indexing, it seems to me that we ought to at least push to make sure that we get that if nothing else.

Mr. SWAIN. I absolutely agree.

Representative MARRIOTT. Because I doubt we are going to get any of this type of thing in on the ventures if we wind up gutting next year's tax cut and eliminating indexing, so maybe we need to even start at that level as far as most small businesses are concerned.

I thank you, Mr. Chairman.

Representative NOWAK. Thank you, Mr. Marriott.

Mr. Weber.

Representative WEBER of Ohio. Mr. Swain, do you think that those tax changes would also be the most beneficial, as well as the most likely or doable in your recommendations?

Mr. SWAIN. Well, it is in the eyes of the beholder how beneficial any particular change is. As Congressman Marriott just pointed out, most small businesses are sole proprietors or partners and so some of the more technically oriented tax changes that have involved particular types of corporations are not applicable to them.

On the other hand, sometimes those companies that have the greatest potential for growth have to take advantage of some of the technical provisions such as subchapter S and section 1244, or whatever. We can certainly provide the committee with some estimates of revenue loss or revenue gain to small business, in an attempt to try to assist the committee in prioritizing and what is more or less important. The beauty of a tax revision is often in the eyes of the beholder, though.

Representative WEBER of Ohio. Thank you.

Representative NOWAK. We have had very comprehensive discussions in this committee concerning the various incentives over the last couple of years and a lot of those incentives depended upon whether the company or self-proprietorship or small corporation was labor-intensive or capital-intensive. The various capital-intensive initiatives that were out there when we went through the 1981 changes, especially looking at the salary depreciation portion, really have not had the kick that we believed they would, because of the general state of the economy.

You have a lot of mixed signals because even if you target to a special area of the small business community, you still may not be hitting the so-called apple with the arrow. So we know that there are mixed results in all of these incentives. However, I do agree

that if we could narrow the options so that we could produce the most effective ones with the least possible revenue loss, we may be able to put that into a small package that has a good chance of being passed.

It looks like the individual tax cuts will be kept in as they were first passed. I don't see any way that they will be taken out or decreased or moved up even with this morning's comment by the President.

We may have, I think, an excellent opportunity to put some incentive into small business area this year, and we look forward to working with you and certainly getting your advice as we try to sort through all of these initiatives.

Mr. SWAIN. Thank you, Congressman, we will certainly do our best for you.

Representative NOWAK. Thank you very much for appearing, Frank.

Senator D'AMATO. Mr. Chairman, I would just like to address one other comment or observation.

I understand that Treasury had one person at this conference as kind of an observer. Do you think that Treasury's input was sufficient at that conference?

Mr. SWAIN. Well, they did have one person on the executive committee, and that was John Kelly, who is an assistant secretary and he was active on the executive committee. I don't know how many people they had as actual attendees.

I think that certainly when the SEC convenes the planning committee for the conference that they hold next year, any additional involvement by the tax policy official of the Department of Treasury would be very welcome and productive.

Senator D'AMATO. OK.

Representative NOWAK. Thank you very much.

We will now, I think, panel the last three witnesses. We would like to call up from Freed, Maxick, Sachs and Murphy, Robert M. Glaser, is he here? Bob, if you would come up to the microphones and he will be accompanied by Donald Pollack.

Mr. Glaser is a partner in the Buffalo accounting firm of Freed, Maxick, Sachs & Murphy. He has had 14 years of public accounting experience.

Mr. Pollack also has been with that firm and has very extensive public accounting and tax experience and has a list of clients that range from 1- or 2-man operation to people that are dealing with $80 million in sales.

Their firm has grown in Buffalo in the last few years and now numbers approximately 50 accountants. It is a pleasure to have you before us.

Before you give your testimony, let me bring up the other two witnesses that we will ask questions as a panel. We will withhold individual questions until we get through hearing everybody's general testimony.

Prof. Howard H. Stevenson is on the faculty of Harvard University and if you would come forward, Mr. Stevenson. He is at the present time Sarofim-Rock professor of the Business Administration Division at Harvard University. He was also a member of the executive committee of the SEC forum and perhaps just as impor-

tant, was a successful small businessman prior to taking on those positions.

Our third panel member is Peter McNeish, who is from the National Association of Small Business Investment Companies. He was also a member of the executive committee of the SEC Forum, and was formerly associate administrator of investment at SBA for, I think, over 5 years.

So you are all well qualified and we appreciate your taking the time to bring some outside comment to the SEC forum results.

Representative MARRIOTT. Mr. Chairman.

Representative NOWAK. Yes, Congressman.

Representative MARRIOTT. I wonder if I might just make a statement at this point that I do have to leave. I have an appointment with the guru of the interest rates, Paul Volcker, who is waiting upstairs and I would like to hear these testimonies and I would like to have copies of them so I can read them.

I would ask the panel if they would excuse me so that I might leave. I am not leaving them because I do not want to hear them; I am leaving for other commitments, and if you would excuse me at this time, I would be most appreciative.

Representative NOWAK. Well, Mr. Marriott, if you are meeting with Mr. Volcker, if he would like to come down and explain interest rates to us, I think you could mention we would be happy to have him and may even stay over.

Representative MARRIOTT. I will give it my best, Mr. Chairman.

Representative NOWAK. We have now the testimony from Mr. Glaser.

PANEL CONSISTING OF ROBERT M. GLASER; HOWARD H. STEVENSON; AND PETER F. McNEISH

TESTIMONY OF ROBERT M. GLASER, CPA, FREED, MAXICK, SACHS & MURPHY, ACCOMPANIED BY DONALD C. POLLOCK

Mr. GLASER. Chairman Nowak, Chairman D'Amato, and other esteemed members of this joint committee, I would like to express our appreciation to be able to testify before such an important committee hearing such as you are conducting today.

Our perspective is a little bit different from that of the previous testifiers in that we are a small business and a large number of our clients are also small businesses. We live day to day in the world of small business, which gives us, I think, a unique perspective in understanding the problems of the small businesses. We are aware of their frustrations. Western New York is not unlike other heavily industrialized areas of the country encountering severe problems because of the severe economic situation.

The condition of the small business segment of our economy today is more heavily burdened than ever before thus hindering its role as one of the major job contributors in this country.

As a matter of fact, in New York State, 98 percent of the businesses have fewer than 100 employees. However, today's economic environment has magnified the hurdles for these businesses and the changes that we are talking about today, some of which might be considered quite revolutionary, are very important steps that must be taken.

In 1982, through October, there have been approximately 23,000 bankruptcies in this country, as compared to 15,000 for the same period in 1981. In western New York, we have approximately 14-percent unemployment in an area not unlike other industrialized areas. The steel industry and the auto industry are laying off people in record numbers and the question remains, where will those people go to?

As Congressman Nowak said, one important factor that should be considered by this committee is the fact that some type of job credits should be established. To give you an example, Bethlehem Steel, many years ago, employed 20,000 people in our area. Now employment is down to 5,000 people, there are 15,000 people that need jobs and how are we going to retrain them and put them into other jobs? I think a general jobs credit could help do that task.

Through our close involvement with our clients, and our working relationships with the directors of the Council of Small Business Enterprises [COSBE], of the Buffalo Chamber of Commerce, and through initiatives put forward by Mr. Nowak through various business forums within the business community, we noted one very important fact of the small businessman; despite all the problems that he has today, this entrepreneur still desires to take the risk in hopes of succeeding.

It is very important, therefore, that the recommendations as put forward by the SEC's forum report be looked at in a very serious light. These risk-takers, these small businessmen need your help.

One area of the report related to the creation of incentives to invest in small businesses, principally a 10 percent investment tax credit, and the opportunity to defer a portion of capital gains if, in fact, the investor would reinvest in another small business.

To give you an example of what that might do, if a businessman could scrape together $100,000 to put into a business, he might go to a bank and the bank might give him 2 to 1 leverage and lend him $200,000. Thus, he will put $300,000 in the business. If you give him a 10 percent tax credit for that investment, he is not going to put that $10,000 back into his pocket, he is going to put $110,000 into the business, go to the bank, and get $220,000 with a net result of an additional $30,000 being put into his business.

Why is this important? Why is it so important to get this small businessman off and running? There was a recent article in Inc. magazine where the 500 top privately held companies were reviewed. In 1977, they selected these companies using a criteria of sales between $100,000 and $25 million, definitely small businesses, and they tracked them. Their performance was incredible. In that 5-year period of time, their work force increased 315 percent. The Fortune 500 industries in that same timeperiod increased employment 2 percent.

I submit to you that small businesses are a way to create employment in this economy because, quite frankly, I do not believe that the steel industry or the auto industry will ever go back to the proportions of the employment they have had in the past.

A common characteristic of the small business is that they are not capital-intensive, but rather labor-intensive, as Mr. Nowak had indicated earlier. We believe, from our perspective of being involved in small businesses, that the accelerated cost-recovery

system adopted in 1981, which was since reduced, did not do what its intended effect was. Somehow, through a general jobs tax credit with the Government recognizing the predominant characteristic of the small business, a truer proportionate share of incentives can be made available to the small businesses.

Also, treatment of section 385, the so-called debt-equity rules, need clarification and revision. This particular section of the Tax Code is one of the most complex, least defined and most pervasive in terms of its negative effects on the mainstream of everyday commercial corporate life. We have seen situations where a potential investor would not invest in a business because of the severe consequences and problems surrounding this particular section of IRS Code.

Finally, Freed, Maxick, Sachs & Murphy wishes to express our appreciation to Chairman Nowak and Chairman D'Amato and the members of the subcommittees for their leadership and support in working to correct the inequalities which have existed in the small business environment.

We applaud your success in having achieved the passage of the simplification of the application of LIFO inventory accounting and the postponement of the section 385 debt-equity regulations which I mentioned a moment earlier.

My firm is confident that small business, and therefore the country, will be benefitted by your continued efforts. In particular, on behalf of the business community in western New York, I would like to single out Chairman Nowak for his positive contributions to, and close involvement with, the business community.

As Senator D'Amato noted earlier, implementation of these recommendations are not going to be easy, they are going to be very difficult.

However, you, the members of these esteemed committees represent not only the hope of the small business community, but, in our beliefs, the hope of the future of the economy of this country.

Thank you very much.

[Mr. Glaser's prepared statement follows:]

PREPARED STATEMENT OF ROBERT M. GLASER, CPA, FREED, MAXICK, SACHS & MURPHY

Chairman Nowak, Chairman D'Amato, and other esteemed members of the Committees, I appreciate the opportunity provided to me and my firm to participate in this very important joint House-Senate hearing concerning the recommendations of the Securities and Exchange Commission's Forum Report on Small Business Capital Formation.

My name is Robert M. Glaser and I am a Partner in the accounting firm of Freed, Maxick, Sachs, and Murphy, PC of Buffalo, New York. As a successful accounting firm of approximately 50 personnel, we have a sizable concentration of clients in the small business category with revenues ranging from less than $1,000,000 to $80,000,000 and having both multiple state and international operations. Accordingly, we are aware of the frustrations and difficulties small businesses' experience in their efforts to achieve some measure of success. Western New York, not unlike other one-time heavily industrialized areas throughout this country, has been particularly hard hit during this period of economic upheaval. The condition of the small business segment of our economy is today more heavily burdened than ever before, thus hindering its role as a major contributor to job creation in this country.

As we are all keenly aware, small businesses have historically been subjected to a number of impediments in their efforts to secure and develop capital. However, today's economic environment has magnified the hurdles confronting the small busi-

nesses warranting that significant, and quite possibly revolutionary measures be taken.

Through our close involvement with our clients and our working relationship with the Directors of The Council of Small Business Enterprises (COSBE) of The Buffalo Chamber of Commerce, we have noted that despite the number of difficulties confronting small businesses, the desire of the entrepreneur to take a risk in hope of succeeding still continues. Yet in many ways, the "risk taker" is not helped, nor provided incentives beyond his own internal makeup or motivation. In the draft report "Recommendations Made at SEC Government-Business Forum on Small Business Capital Formation" (Forum Report) there are a number of relevant issues raised, and recommendations offered which, if implemented, would serve to reverse the seemingly negative attitude of Government towards small businesses and finally acknowledge the unique and significant contribution of the "risktakers" to the overall economic strength of the Country and creation of jobs—They Need Help!

Of particular interest to us are those recommendations of the Forum Report for change in various tax areas. Implementation of these recommendations would result in the recognition by government of the rather unique nature of small business, provide for realistic incentives for individuals to infuse capital into small business and limit the unfortunate rechanneling of efforts and resources of small businesses when challenged by the Internal Revenue Service.

The balance of this statement reflects our specific comments on certain of the recommendations of the Forum Report.

DEVELOPING INCENTIVES TO INVEST IN SMALL BUSINESS

The recommendation to provide a 10 percent investment tax credit for funds invested in a qualified small business and the recommendation to defer a portion of the capital gains on liquidation of an investment if it is reinvested in a new qualified small business would, if adopted, stimulate the growth and formation of small businesses. Currently, many investors find it easier to put their money into the stock or bond market where investments are liquid. Smaller businesses do not have access to these markets and therefore, such investments are not always readily marketable. The incentive created by the adoption of the above recommendations would create an additional reward for the "risktaker" resulting in an increase in capital for small business. This expansion of available capital would ultimately stimulate the economy through the creation of more jobs.

CHANGE IN CORPORATE TAX RATES

A source of capital to any business is its retention of net profits. Under the present tax law, approximately 26 percent of the first $100,000 of the pretax profits of a business must be paid out as Federal income taxes. To a small business, even those successful enough to generate such profits, the payment of $26,000 represents an appreciable portion of its annual cash flow. A change in the graduated tax rate structure providing a ceiling of $500,000 takes into consideration the nature of a small business and the real impact that the tax dollar payment has on operating requirements and is clearly needed. Very simply, not every business is a multinational conglomerate. We would support such legislative action as is recommended in the aforementioned report.

We likewise view the recommendation that the accumulated earnings tax exemption be raised from its present level of $250,000 as a very positive move for small businesses. In fact, we suggest that the entire Section of the Code be repealed in that it is indicative of the negative perspective: "to be successful warrants a penalty." Furthermore, the assertion of the additional "tax liability" because of excessive accumulation of earnings is a clear example of a situation where a small business is forced to redirect its efforts and resources in that the "burden of proof" rests with the taxpayer, not the Internal Revenue Service. In today's economic environment, $250,000 of accumulated earnings can be eroded with one bad year.

Changes enabling small businesses to apply the concept of income averaging would also serve to retain capital, particularly in the initial years of a new business. Assuming the graduated tax rate structure is unchanged and a new company has taxable income of $20,000 for 1982, and increasing $20,000 annually for the next four years to the level of $100,000 in 1986, the cumulative tax paid over this period would amount to $64,000 of which approximately $26,000 was derived from the 1986 income of $100,000. Extending, however, the income averaging concept to the new company would result in a tax payment of only $23,000 in 1986; or approximately $3,000 (11.5 percent) lower than as presently structured.

CHANGES IN TAX TREATMENT OF CAPITAL GAINS

Another of the recommendations which would work toward improving the ability of small business to secure capital relates to the modification of the regulations surrounding the investment interest limitation. Generally speaking, under present tax law an investor's deduction for interest expense incurred on borrowings, which are in turn invested to obtain less than a 50 percent equity interest, is limited to $10,000 plus net investment income. Likewise, the current limitations for ordinary loss treatment associated with corporate equity securities should be restructured as set forth in the Forum Report.

The presence of these limitations are clearly a deterrent to a small business' efforts to obtain needed capital. We, in our practice, have encountered numerous occasions where these limitations prevented a client from obtaining the needed capital. All elements of the "marriage" were present but it was not consummated because either or both of these hurdles could not be overcome, and consequently, a new business was not created.

ADDITIONAL TAX MODIFICATIONS

The Forum Report also suggests the need for further liberalization of Subchapter S regulations of the Internal Revenue Service Code to include: increasing the number and type of eligible shareholders, extending the time period for making the appropriate election and enabling Subchapter S Corporations to issue more than one class of stock and form Domestic International Sales Corporations (DISC).

The more recent changes in the regulations relating to Subchapter S Corporations as set forth in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and Subchapter S Revision Act of 1982, indicate a movement toward liberalization which should serve to stimulate the use of this form of corporate organization; particularly in the initial years of enterprise's existence. Generally, during the first three to five years of a business' existence the results of operations are more likely to yield losses rather than income. Under a Subchapter S Corporation election these losses are allocated much the same as in a partnership arrangement, to the individual investors for inclusion in their respective individual returns. Thus, in a Subchapter S Corporation arrangement, there is the incentive to invest because of the presence of the "loss benefit" passing on to the investor. However, as is noted in one of the Forum Report recommendations, the present Subchapter S regulations, unlike the partnership regulations of Subchapter K, limit investors to natural persons, estates and certain forms of trusts. Accordingly, other extremely viable sources of capital such as partnerships and other corporations are precluded.

Another aspect of the Subchapter S regulations which should be changed involves the computation of an investor tax basis for enabling the pass through of operating losses. Under present law, a Subchapter S Corporation investor is limited in the amount of reportable losses to be deducted to the amount of capital invested in the business, plus the amount of direct loans made to the corporation. Under the partnership regulations a partner's basis includes the partner's pro-rata share of the partnership's obligations. The absence of such an advantage is again a deterrent to securing investment capital for small business.

The present Subchapter S regulations also restrict the number of shareholders to a total of thirty-five. Expansion of this level, as is recommended in the Forum Report, to as many as 100 shareholders together with the recent changes in the Federal Securities Laws involving exempt Regulation D offerings would provide for a much more attractive investment product for the solicitation of equity funds. Furthermore, a revision in the regulations to allow for secondary offerings of different securities, would provide small businesses with the opportunity to secure future capital beyond its initial formation needs.

A common characteristic of the small business is that they are not capital intensive but rather labor intensive. Consequently, many of the tax incentives do not have the applicability or provide the same form of benefit to the small business as they provide to the medium and larger businesses. The Accelerated Cost Recovery System adopted in 1981 and the Investment and Energy Tax Credits (since reduced by TEFRA) do not yield a proportionate incentive to this category of business. The general jobs tax credit did provide "an incentive" which could be availed upon by small business. As was noted in past testimony, only about 12 to 13 percent of the corporate share of business tax reductions will flow to the small corporations, which as a group pay over 20 percent of the Corporate business taxes. The disparity is apparent and warrants revision. Reinstitution of the general jobs tax credit would represent Government's recognition of a predominate characteristic of the small busi-

ness and serve to allocate to this segment "a truer proportionate share" of the tax incentives available.

Another aspect of the corporate tax law identified in the Forum Report is the suggestion that enterprises with annual sales of less than $3,000,000 be provided the opportunity to elect application of either the cash or accrual method of accounting for its business activities. Under present law, if an enterprise "operates out of" or maintains an inventory of product which is used for income generation, this enterprise must use the accrual basis of accounting. The inherently beneficial aspect of the cash method of accounting is that it is the simplest method of bookkeeping and therefore the least expensive to operate. Generally speaking, use of the cash basis method versus the use of the accrual basis method will provide an initial deferral of taxable income and accordingly, a lower tax liability. Again, a very real benefit to a business in its startup period because of the need to finance operations.

Additionally, a vast number of the operators of small businesses think and act in terms of the business' available cash rather than in terms of its operating results determined under the accrual method of accounting. Because of the restrictive nature of the current tax law in this area, a small business very often finds itself confronted with a very real tax problem because a very good business arrangement was made within the framework of the cash basis orientation and for tax reporting purposes the accrual method must be followed. Relaxation of the requirements for the application of the accrual method for tax reporting purposes to either a certain level of sales or inventory on hand would be extremely beneficial in removing some of the problems facing small businesses.

SECTION 385: TREATMENT OF CERTAIN CORPORATE INTERESTS AS STOCK OR INDEBTEDNESS

It is of particular significance to note that in all of the recommendations included in the Forum Report, the commentary suggests a repeal of the entire Section. This particular Section of the Tax Code is one of the most complex, least defined, and most pervasive in terms of its negative effects on the mainstream of every day commercial corporate life. Earlier in this statement, reference was made to the seemingly negative attitude of Government to the "risktaker" or "aggressive entrepreneur." This particular Section of the Internal Revenue Code is a clear expression of this attitude. Under the regulations and the myriad of case rulings, borrowings from shareholders are treated as negatives. In general terms, if a company has debt instruments outstanding, a significant amount of which is held by investors, resulting in a debt to equity ratio of more than 3 to 1, the Internal Revenue Service can assert the position that some or all of this "shareholder-related debt" is not debt and recharacterize the funds as additional equity investment. The consequences of such a recharacterization is the disallowance of the interest expense of the company and in certain limited instances, the revocation of the Subchapter S Corporation status.

In a typical small business, the ability to secure external financing is limited very often to asset-based arrangements. However, the small business typically is not capital intensive, as was noted earlier, and consequently, its borrowing strength is limited. Furthermore, if a shareholder provides supporting guarantees, the risk is present for recharacterization of the transactions by the Internal Revenue Service as one in which a loan was first made to the shareholder who in turn made a loan to the Company.

Accordingly, while traditional reasons have limited small businesses from obtaining adequate external financing, this Section of tax law makes it extremely difficult to obtain "internal" financing. Despite the entrepreneur-shareholder's motivations and willingness to "take a risk" and infuse more funds into the operations they may not necessarily be able to do it in such a fashion which provides for a return on investment vis a vis interest on borrowed funds. The alternatives outlined in the Forum Report, should mitigate the counterproductive nature of this segment of the tax law.

In very simple terms, since the triggering level of the problem arises when an enterprise's internally provided (shareholder) debt exceeds its equity or net worth by more than three times, avoidance of difficulties can be achieved by increasing the ratio in absolute terms. While this would seem to be the easiest solution variations of this approach could very well be, as suggested in the Forum Report: (a) the exclusion from the computations of say the first $1,000,000 of debt; (b) or provide that the equity component of the equations be determined under a moving average basis over time; (c) or provide for asset valuation adjustments to flow into the equity determination.

To illustrate these variations, let us assume the following: A company has debt of $300,000 and an equity of $105,000; during the current year it incurs an operating loss of $10,000, reducing its equity to $95,000. At the end of the current year, its debt to equity ratio is greater than 3 to 1 ($300,000 to $95,000) or 3.2 to 1. By determining equity on the moving average approach it would not have a ratio in excess of the safe harbor level. Year 1 ending equity plus year 2 equity divided by 2 equals $105,000 + $95,000 divided by 2 or $100,000, which when compared to the debt outstanding as compared to the debt outstanding at the end of year 2 would result in a ratio of 3 to 1; the safe harbor level.

The other suggested approach is to modify the component values of the equity equation which consists of assets less liabilities. By providing for a modification in the measurement of the value of assets, the equity value can be adjusted.

Under traditional tax and accounting principles, assets are recorded at the lesser of their cost or market value, which may not be a true measure of their value or worth. For example, real estate has historically appreciated in value over time. Modification, for purposes of Section 385 evaluation, of the method of determining a company's equity to include the effect of unrealized appreciation in the value of its assets would provide relief to the highly leveraged enterprise from assertion of the "excess debt" regulations. An alternative to the fair market value approach, which can become a somewhat expensive exercise to a small business, in obtaining appropriate appraisals could be the use of the changes in the Consumer Price Index for arriving at the adjustment factor.

As has been noted throughout this presentation the traditional "make or break" period of a new company encompasses a period ranging from three to seven years. During this period, a new enterprise is very often struggling to get a share of a market, working to solve countless problems ranging from production scheduling control, product quality control, marketing programs, employee relations, coping with innumerable regulatory agencies and the vagaries of the economy. Very often, it does not solve all of these problems quick enough, the operating results suffer, and cash flow is adversely impacted necessitating the incurrence of debt. Conversely, rapid growth, a good problem, must very often be financed from outside sources. Both of these situations are relatively commonplace during the growing years of a small business, and, as is recommended in the Forum Report, serious consideration should be given to exempting companies from compliance with section 385 requirements during these formative years. The use of borrowed funds to supplement internally generated cash flow to either assist in the resolution of problems or enable expansion of an enterprises' operations should not be rewarded with such onerous consequences as are currently provided for within the Internal Revenue Code Section 385.

OTHER

There are a number of other very realistic and needed reforms identified in the Forum Report which must be addressed if the ability of the small business to secure and retain needed capital is to be improved and the Nation as a whole benefited by their continued contribution to our economy.

Finally, Freed Maxick Sachs & Murphy, PC expresses its appreciation to Chairman Nowak and Chairman D'Amato and the Members of these Committees for their leadership and support in working to correct the inequalities which have existed in the small business environment. We applaud the success of your having achieved the passage of the simplification of the application of LIFO inventory accounting, and the postponement of the Section 385 "debt-equity" regulations. My Firm is confident that small business and therefore the Country will be extremely benefited by your continued efforts.

Representative NOWAK. Thank you very much, Mr. Glaser, and we will turn now to Professor Stevenson and have his comments and then go on to Peter McNeish before we get into the general questions.

Professor Stevenson.

TESTIMONY OF HOWARD H. STEVENSON, PROFESSOR OF BUSINESS ADMINISTRATION, HARVARD UNIVERSITY

Mr. STEVENSON. Thank you, Chairman Nowak, and Chairman D'Amato.

I am pleased to appear before you to discuss some of the recommendations made by participants at the first "SEC Government-Business Forum on Small Business Capital Formation."

As a former small businessman and currently a professor of business administration, I looked forward to serving on the executive committee of the forum in the hope that innovative and useful recommendations could be developed to assist the capital formation process for small business. I believe that the forum succeeded in developing such recommendations.

I would like to briefly outline some of the forum recommendations concerning the access to financial institutions and equity areas. I should stress that the recommendations are not presented in order of importance because the forum participants did not classify the recommendations in that manner.

I shall discuss only a small number of worthwhile recommendations.

Concerning access to financial institutions, the participants supported strongly the recommendation that Congress adopt the small business participating security. This hybrid form of security discussed earlier, including the tax features, capital gains treatment, deductibility by the small business of the profits and interest paid out on the security and an investment tax credit.

Bills already have been introduced supporting this concept, and while they differ in certain respects, the small business participating securities concept could help to satisfy the financing needs of small companies by attracting new investments in small business.

It is anticipated that the proposal would generate capital investment, new jobs, and over a long term, additional Federal revenue.

The forum participants also recommended a capital bank should be created to create a stable, continuing source of leverage for the SBIC industry. That bank, which would be federally chartered, would be similar to existing entities such as FNMA and the National Consumer Cooperative Bank.

On the basis of historical default and loss ratios of SBIC debentures. It is estimated the bank could eventually support an aggregate SBIC industry, borrowing in the range of $2 to $3 billion. The SBIC Capital Bank would have the following principal features: It would be privately managed, it would be initially capitalized by the U.S. Treasury at a level of $100 million, which would represent a single, one-time, nonrecurring investment by the Federal Government. The Treasury investment would be retired over time out of profits from the bank.

As you know, recent budget cuts have limited the authorized funding for the SBIC program for fiscal year 1982 and 1983 to a maximum of $160 million per year. These restrictions in the availability of leverage have occurred at a time when the need and demand for leverage have increased. Accordingly, there is a need for Congress to establish a stable source of continued funding support, such as a capital bank, for the Small Business Investment Company industry [SBIC].

There were, as mentioned, a number of recommendations in the pension area, most of which relate to the Employee Retirement Income Security Act of 1974 [ERISA]. I am pleased to inform you

that congressional action would not be required to implement the forum recommendations in this complex area.

One point is clear, the Department of Labor, in conjunction with other appropriate Governmental agencies, must disseminate to the fullest extent possible its position that investments by employee plans in smaller companies are not, per se, imprudent.

In a 1979 prudence regulation, the Department of Labor indicated that investments by employee plans in small business are neither per se prudent nor per se imprudent and a small business investment may be viewed in the context of investment strategy for the entire plan portfolio.

The Department did not offer any criteria, however, to assist plan managers in determining the degree to which investment in small business may be prudent. In addition, the Department's policy has been to avoid passing judgments on particular investments.

This lack of guidance has particularly diminished the amount which plans invest in small business. Reportedly, and from my personal experience, many plan administrators do not believe that investment in certain small businesses is appropriate for pension plans under any circumstances.

Although the Department of Labor has taken some steps to clarify its position, its message clearly has not reached everyone. As a consequence of uncertain signals emanating from the Department of Labor, the ERISA prudent person rule has not been permitted to operate as effectively as it could. A further effort by the Department to disseminate its position may be prudent for employee plans to invest additional assets and would certainly be appropriate.

The forum participants also urged the Department of Labor to adopt a definition of the term "plan assets" referred to earlier. This is a critical factor for the continuing investment in small business by venture capital firms.

In addition, the forum participants recommended that pension funds and other institutions should be encouraged to utilize intermediaries experienced in small business financing in order to facilitate investment in small business. Although there is a growing recognition that institutional investments in small business are desirable, pension fund and other asset managers often do not have the expertise nor the time necessary to research and select promising small business investments.

In particular, institutional investment managers would have to devote considerable resources to the investigation of these investments. However, the cost of obtaining and analyzing information on potential small business investment is only one factor that deters institutional investment.

Since small business investments are often in companies with low liquidity or a volatile market, the resultant uncertainty about resale value makes them stay away.

Moreover, many small businesses can only absorb a limited amount of funds.

In response to the problems that accompany small business investments, a number of approaches have developed in both the public and private sector to take advantage of the benefits that

small business investments can offer to pension funds and other institutions.

These approaches serve to minimize risks and costs previously associated with small business investment. In general, these approaches involve the use of at least one intermediary between the institution and small business.

Before concluding, I would like to mention one forum tax recommendation concerning the repeal revision of the debt-equity regulations under section 385. As you have heard before, this is a serious impediment to investment in small business. Although Congress apparently intended the regulation to be tax neutral, and left it to the Treasury Department to issue the regulations, the lack of clarity in the resulting regulations and their complexity is overwhelming in practice. Congress deems that statutory provisions are still necessary, the forum recommended that the Treasury Department provide limited exemptions and safe harbors in order to reduce the impact these regulations would have on the small business community. Small business organizations and others have supported such an approach, noting that the regulations proposed, if implemented, would have a chilling effect on small business capital formation. Since the regulations are tax neutral, the limited exemptions and safe harbors being proposed would not disrupt current efforts to reduce the Federal budget deficit.

As you can see, there are no quick fixes for the problem of small business capital formation. However, we believe that the implementation of the forum recommendations would have a significant positive impact on the small business community.

Thank you for this opportunity to testify.

[Mr. Stevenson's prepared statement follows:]

PREPARED STATEMENT OF HOWARD H. STEVENSON, PROFESSOR OF BUSINESS ADMINISTRATION, HARVARD UNIVERSITY

Thank you, Senator D'Amato, Representative Nowak and distinguished members of the committee. I am pleased to appear before you to discuss some of the recommendations made by the participants at the first SEC-Government Business Forum on Small Business Capital Formation. As a former small businessman and current professor of business administration, I looked forward to serving on the Executive Committee of the Forum in the hope that innovative and useful recommendations could be developed to assist the capital formation process for small business. I believe that the forum succeeded in developing such recommendations.

I would like to briefly outline some of the Forum recommendations in the access to financial institutions and debt equity areas. I should stress that these recommendations are not presented in order of importance, as the Forum participants did not classify the recommendations in that manner, and that I will be able to discuss only a small number of the worthwhile recommendations generated by the Forum.

In the area of access to financial institutions, the participants recommended that Congress adopt a "Small Business Participating Security," a hybrid form of security that would offer both a fixed rate of interest and a percentage of profit to the investors. Such a security would include such tax features as:

A. Capital gains treatment on the shares of profits paid to the investors;

B. Deductibility by the small business of the profits and interest paid out on the securities; and

C. An investment tax credit to the investor for such investment.

Bills supporting such a security have been introduced in recent years by Representatives Marriott and Eckart and Senator Weicker. While the bills differ in certain respects, the Small Business Participating Security concept could help to satisfy the financing needs of small companies by attracting new investors to the area of small business. It is anticipated that the proposal would generate capital investment, new jobs, and hopefully in the long-term, additional federal revenues.

The Forum participants also recommended that a "Capital Bank" should be created to provide a stable, continuing source of leverage for the Small Business Investment Company industry. The bank, which would be federally chartered, would be similar to existing entities, such as the Federal National Mortgage Association and the National Consumer Cooperative Bank. On the basis of historical default and loss rates of SBIC debentures, it is estimated that the bank could eventually support aggregate SBIC industry borrowings in the range of $2-$3 billion.

The SBIC capital bank could have the following principal features:

a. It would be privately managed and would utilize the resources and techniques of the private sector.

b. It would be initially capitalized by the U.S. Treasury at the level of $100 million. This would represent a one-time, non-recurring investment by the federal government; and

c. The Treasury investment would be retired over time out of profits earned by the bank.

Recent budget cuts have limited the authorized funding for the SBIC program for fiscal 1982 and 1983 to a maximum of $160 million per year. These restrictions in the availability of leverage occur at a time when the need and demand for leverage have increased. Rapid growth of the industry over the past several years, an increased rate of demand for venture capital and the rollover of maturing SBIC loans, which must be taken out of annual appropriations, have escalated the SBIC industry's need for leverage. Accordingly, there is a need for Congress to establish a stable source of continued funding support, such as a Capital Bank, for the SBIC program.

There were a number of recommendations in the pension area, some of which relate to the Employee Retirement Income Security Act of 1974 or "ERISA." I am pleased to inform you that Congressional action would not be required to implement the Forum recommendations in this complex area.

One recommendation in the pension area is for the Department of Labor, in conjunction with other appropriate government agencies, to disseminate to the fullest extent possible its position that investments by employee plans in smaller companies are not per se imprudent.

In a 1979 prudence regulation, the Department of Labor indicated that investments by employee plans in small business are neither per se prudent nor per se imprudent and that a small business investment may be viewed in the context of the investment strategy for the entire plan portfolio. The Department has not offered any criteria, however, to assist plan managers in determining the degree to which investment in small business may be prudent. In addition, the Department's policy has been to avoid passing judgment on the prudence of a particular investment for a plan. This lack of guidance may have had a dampening effect on the degree to which plans invest in small business since plan managers do not have a clear basis for determining the portion of a plan's assets that may be prudently invested in small business.

Reportedly, there are a number of plan administrators who still do not believe that investment in at least certain small businesses, such as venture capital firms, would be appropriate for pension funds under any circumstances. Although the Department of Labor has taken some steps to clarify its position, its message has yet to reach everyone. As a consequence of uncertain signals emanating from the Department of Labor, the ERISA prudent person rule has not been permitted to operate as effectively as it could. A further effort by the Department to disseminate to the fullest extent possible its position that it may be prudent (i.e., not per se imprudent) for employee plans to invest additional assets in small business would be appropriate.

The Forum participants also urged the Department of Labor to adopt a definition of the term "plan assets" under ERISA to permit venture capital managers to continue to invest pension plan funds without qualifying as plan fiduciaries and without venture pool assets qualifying as plan assets.

In August 1979, the Department of Labor proposed a definition of the term "plan assets" under ERISA. Under the Department's proposal, there would have been a "look-through" of the interest held in a venture capital pool by an employee plan so that pool assets would have been deemed to be plan assets under ERISA. This would have created a number of problems for venture capital pools under ERISA.

In reply to the views expressed concerning the proposed plan asset regulation, the Department of Labor, on June 6, 1980, proposed for comment a revised definition of the term "plan assets." The proposed revision provides that if certain conditions are met, an investment in a venture capital pool by a plan would not be considered to

be a delegation of investment management authority and the venture pool assets would not be considered to be plan assets under ERISA.

The Department of Labor has not yet adopted the revised plan assets definition as it applies to venture capital firms. The Department is urged to adopt a definition of the term "plan assets" that would permit venture capital managers to invest pension funds without qualifying as plan fiduciaries and without venture pool assets qualifying as plan assets.

In addition, the Forum participants also recommended that pension funds and other institutions should be encouraged to utilize intermediaries experienced in small business financing in order to facilitate investment in small business.

Although there is a growing recognition that institutional investments in small business are desirable, pension fund and other asset managers often do not have either the expertise or time necessary to research and select promising small business investments. In particular, institutional managers would have to devote considerable resources to the investigation of small business investments. However, the cost of obtaining and analyzing information on potential small business investments is only one factor that deters institutional investment in small business. Small business investments often are not liquid or may have a volatile market that results in uncertainty about resale value. Moreover, many small business investments can only absorb a limited amount of funds.

In response to the problems that accompany small business investments, a number of approaches have been developed in both the private and public sectors to take advantage of the benefits that small business investments can offer to pension funds and other institutions. These approaches serve to minimize the risks and costs previously associated with investments in small business. In general, these approaches involve the utilization of at least one intermediary between the institution and the small business. Intermediaries currently available for use by pension funds include venture capital firms, Small Business Investment Companies, small company investment funds, broker-dealers, and state investment programs. Both private and public pension funds are encouraged to further explore the potential investment assistance that these and other intermediaries can provide in developing small business investment opportunities.

Before I conclude, I would like to mention one Forum tax recommendation concerning repeal or revision of the debt-equity regulations under Section 385 of the Internal Revenue Code.

The question of whether advances to a corporation are to be treated as debt or equity for federal income tax purposes has been one of the most frequently litigated issues in the tax law. The vast majority of these cases raise the issue of whether the payment by the corporation to the security holder is a deductible interest payment or non-deductible dividend distribution. Over the years the courts have resolved the issue on an ad hoc basis. The situations in which this issue arises are disparate and the courts have not established rigid formulas or litmus paper tests. In an attempt to develop guidelines and factors for resolving this issue, Congress, as part of the Tax Reform Act of 1969, added Section 385 to the Internal Revenue Code. Realizing the difficulty in drafting a comprehensive debt-equity scheme, Congress in Section 385 authorized the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated as stock or indebtedness. However, although the issue is the subject of continuing debate, many contend that neither Section 385 nor the recently released regulations lend clarity or certainty to a debt-equity determination. Additionally, both impose undue burdens on capitalizing and organizing small businesses. Accordingly, repeal of Section 385 is recommended.

However, if the statutory provision is determined by Congress to be necessary, the Forum recommended that the Treasury Department provide limited exemptions and safe harbors in order to reduce the impact these regulations would have on the small business community. Small business organizations and others have supported such an approach, noting that: (1) these regulations, if implemented, would have a chilling effect on small business capital formation; and (2) since the regulations are tax neutral, the limited exemptions and safe harbors being proposed would not disrupt the current efforts to reduce the federal budget deficits.

As you can see, there are no quick fixes for the problems of small business capital formation. We believe, however, that implementation of the Forum recommendations would have a significant positive impact on the small business community.

Thank you once again.

Representative NOWAK. Thank you very much, Professor.

We have our last witness, Peter McNeish. Peter.

TESTIMONY OF PETER F. McNEISH, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. McNEISH. Thank you, Congressman.

Chairman D'Amato and Chairman Nowak, as a member of the executive committee of the SEC forum, and as an active participant in the small business community, I am pleased to have the opportunity to testify on the subject of small business capital formation and retention.

I should first of all commend the SEC for the fine job they did in putting on the conference and your committees for holding these joint hearings in such timely fashion.

The real accolades, however, go to the many small business persons who gave their talent and their time to make sure the conference truly reflected the views of small business.

They believe, as I do, that the recommendations developed at the conference will, if adopted, significantly advance the capital formation process, stimulate the growth of small business, and create new, permanent jobs for our economy.

I have been asked to discuss several of the forum recommendations in the tax area, and I should immediately duck for a safe harbor myself by laying no claim to being a tax expert. I would like to point out that of the 30 or more resolutions adopted by the forum, over one-half of those did deal with issues of taxation. It was clearly on the minds of the conferees.

Consequently, it is impossible to deal with all of them in detail here so I will just highlight a few. The first forum recommendation deals with modification of the present corporate income tax rate and bracket structure. Under this proposal, the conferees recommended that the highest corporate tax rate be applied only to corporate taxable income in excess of $500,000, as contrasted with the current $100,000 level. The lowest tax bracket, on the other hand, would be increased from the present $25,000 level to what the conferees refer to as a substantially higher base—it was not a specified figure—without increasing the 15-percent rate which will be applicable after 1982. For those taxable income levels between the new base and the $500,000, a series of new graduated tax brackets would then be established.

In light of the difficulties the small firm often faces in obtaining adequate external capital, particularly in these economic times, a primary source of capital for many small firms is retained earnings.

Modifications of corporate tax rates and brackets along the lines being recommended would reduce the tax erosion effect on retained earnings and provide a small expanding enterprise with an internal source of funds necessary to finance their growth.

Several of the other forum recommendations deal with tax incentives designed to stimulate or retain investments in small business. One such proposal, and it has been mentioned earlier, was for an investment tax credit equal to 10 percent of the funds invested in a qualified small business.

This proposal also provides a rollover provision under which the capital gains tax, otherwise payable upon liquidation of any invest-

ment, would be deferred on that portion of the funds which are reinvested again in qualified small business within a specific period of time.

The capital gains tax would be deferred until the subsequent qualified investment is liquidated or until the date of liquidation of the last qualified investment in a chain of transactions.

This recommendation offers the definition of a qualified small business investment that in general includes an equity security or debt instrument issued by a small firm which meets the size standards for an SBIC investment.

Mr. Glaser mentioned one benefit which would result from this proposal; the conferees believe it would also achieve two other objectives. First, to attract new capital to small businesses through the tax credit and the rollover to capital gains from nonsmall business investment.

Second, to encourage funds already committed to small business to be reinvested in such companies when the original investment is liquidated.

There is precedent in the Tax Code for both the concepts which are coupled in this proposal.

The third recommendation I would like to highlight focuses on the long-term capital gains exclusion for certain investments in small businesses. Current law regarding the taxation of long-term capital gains requires an investment be held for more than 1 year before the investor is entitled to claim a 60-percent long-term capital gains exclusion.

In the interest of rewarding realized gains accrued over an extended period of time, which is the primary purpose behind long-term capital gains treatment, the forum recommended the establishment of a two-tiered system, with the capital gains exclusion increasing to 80 percent if the small business investment is held for 5 years.

Such a system would be a better balance between risk and reward and provide a significant inducement to longer term investments in small firms.

On a tax-related matter, the conferees endorsed the retention of tax-exempt industrial revenue bonds for small firms and the ability to package a group of small IRB issues into one large issue.

Tax-exempt IRB's represent one of the only competitive methods by which small firms have access to the long-term bond markets. The conferees felt very strongly that their availability should be retained.

A final recommendation I would like to mention proposes that an individual investor with a substantial equity interest in a small business, who completely sells his shares in that business, may elect a one-time exclusion of a percentage or dollar amount of any long-term gain realized, if the investor has attained the age of 65 and held the investment for 10 consecutive years preceding the sale.

This recommendation may attract additional sources of capital for small firms by offering the substantial investor the potential to earn tax-free income at an age when the investor may be considering retirement.

The recommendation also recognizes that many small business persons who have expended tremendous resources building a business view the equity in that corporation as their prime source of retirement income.

It is comparable to the provision in the Tax Code which permits homeowners to exclude 125 percent of gain in the sale of a home if certain requirements are satisfied, such as attaining the age of 55 and the home having been the principal residence for a specified period of time prior to sale.

As I have already noted, there is a conspicuous absence of any revenue estimates attributable to any or all of its tax proposals. The executive committee of the forum did request that the Treasury Department provide revenue estimates for several of the proposals discussed at the conference and discussed preliminarily by the executive committee before the conference was held.

However, the Treasury Department was unable to produce the data in time for consideration by the conference. In order that such statistics would be available, separate and apart from the Treasury Department, the forum participants recommended the development of an independent small business data base. Such a data base would be make available to legislators, regulators and commentators information necessary to determine the needs of small firms and to assess the impact of legislation and regulatory initiatives on small business.

Before closing my testimony, I would point out that the forum also proposed a series of additional tax changes which are quite important to the process of capital formation for small business.

Several of these items were discussed by earlier witnesses, but let me just touch upon them lightly. First, the permanent restoration of the general jobs tax credit.

Second, reduction of the corporate long-term capital gains tax rate to the same level as the individual capital gains tax rate.

Third, a series of changes in the tax treatment of section 1244 small business stock.

Fourth, as mentioned earlier, a repeal of section 385 of the Tax Code and proposed 385 debt-equity regulations.

Fifth, further liberalization of subchapter S, even beyond the landmark legislation that was passed by Congress just recently.

Finally, the restoration of a meaningful, incentive stock option provision to the Tax Code.

There is not sufficient time to deal with all of these in detail, I would simply say they represent constructive proposals which could have a significant impact on the growth and expansion of small firms.

I would like to take just a moment to address the question that was raised earlier, Senator, about improvements in the forum and its structure. Certainly, I would endorse the comments made by Commissioner Evans, of more small business persons attending and, with a little additional lead time, I think that could be accommodated.

Second, it seems pretty clear now, in light of some of the other questioning and of the interest of the conferees at the conference itself, it might have been appropriate to allow an opportunity for the conferees to try to assess priorities among the various recom-

mendations, as opposed to a long but very meaningful and important laundry list in a variety of fields.

Third is the structural problem of the conference and one to which I don't have an immediate answer. It is clearly difficult at this point to have these kinds of important recommendations without a single-source advocate who is going to followup in a focused way.

Clearly, in my judgment we need a mechanism that would provide some kind of a followup in a cohesive way on a continuing basis. This is certainly something for your committees to consider, be it a joint commission of the Congress or some other makeup. I don't say this to fault the SEC in any way, I just think they are in a very delicate position being an executive branch agency, and not having the legislative authority or tools to address some of the issues that are out of their area of jurisdiction.

Thank you for this opportunity.

[Mr. McNeish's prepared statement follows:]

PREPARED STATEMENT OF PETER F. MCNEISH, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Senator D'Amato, Representative Nowak and distinguished members of the Committees, I am Peter McNeish, Executive Vice President of the National Association of Small Business Investment Companies. I am honored to be here today to testify on a subject of great importance to all of us and to the Nation as a whole—small business capital formation and retention. As a member of the Executive Committee of the SEC Government-Business Forum, and an active participant in the small business community, I believe that several of the recommendations developed at the conference would, if adopted, significantly assist the capital formation process, particularly for smaller businesses. I will be addressing four of the Forum recommendations in the tax area.

I wish to point out that the conference participants did not rank the recommendations, and that my selecting only four recommendations for this testimony is a function of the brevity of my remarks and not the relative importance to be attributed to any of the recommendations.

First, the Forum concluded that Congress should modify the present corporate income tax rate and bracket structure, as follows: The highest corporate tax rate should apply to corporate taxable income of over $500,000, as contrasted with $100,000 at present. The lowest tax bracket should be increased substantially from its present $25,000 level, without increasing the 15 percent rate applicable after 1982. Other graduated tax brackets below $500,000 should be established.

The rationale underlying this recommendation is relatively straightforward. It is well known that the cost and availability of capital plays a key role in the ability of a business to succeed in its startup and growth periods. A prime source of capital for small businesses is, among other things, retained earnings. However, the erosion of retained earnings by corporate over-taxation can inhibit small business expansion, particularly in light of the difficulties often faced in obtaining adequate external capital. Modifications to corporate tax rates and brackets along the lines being recommended would provide small expanding enterprises with a source of funds necessary to finance growth.

The re-examination of the corporate graduated rate and bracket structure is not new. This issue was considered by the delegates to the White House Conference on Small Business in 1980. The ten regional caucuses to that conference produced various proposals for a graduated corporate tax system. The delegates, in the final session, voted modifications to the corporate tax structure, including a corporate surtax threshold of $500,000, the most important recommendation of the conference. The recurrence of this recommendation at a time following the Economic Recovery Tax Act's revisions to the corporate tax rates highlights the relative importance of this issue to the small business community, and the concern for further corporate tax reform.

In a separate recommendation, one which focuses on the capital gains provisions of the Internal Revenue Code, the Forum requests Congress to provide for an Investment Tax Credit, equal to 10% of the funds invested, for investments in a "Quali-

fied Small Business Investment" (QSBI). The recommendation further provides that such credit would not be available for any investment if the source of funds is the sale or other liquidation of a prior QSBI in a transaction occurring less than a specified number of years prior to the date of the new investment. Additionally, the capital gains tax otherwise payable with respect to any investment liquidations, upon election, would be deferred on the portion of the funds which are reinvested in a QSBI within a period of time from the date of the transaction producing such capital gain. The tax would be deferred until a subsequent QSBI is liquidated, or until the date of liquidation of the last QSBI in a chain of transactions. The recommendation offers a definition of Qualified Small Business Investment that in general, includes an equity security or debt instrument issued by a Small Business Investment Company, Business Development Company, or a small business and held by the investor for at least 5 years.

The goals of this recommendation are two-fold: First, to attract new capital to small businesses through the tax credit and the rollover of capital gains from non-small business investments; and second, to encourage funds already committed to small business investments to be reinvested in such companies when the original investment is liquidated. I wish to point out that there is ample precedent for both the tax credit concept and tax deferral on rollover of a capital investment. With regard to the rollover, reinvestments in QSBI seem at least as beneficial to the economy as the similar treatment afforded homeowers on the sale of a principal residence.

The third recommendation I wish to address focuses on the long-term capital gains exclusion for certain investments in small businesses. Specifically, the Forum recommended that Congress amend the Internal Revenue Code to provide that after holding an equity or equity-type investment made directly in a small business for more than 5 years, the seller of such investment would be entitled to exclude 80% of any gain realized.

Current law regarding the taxation of long-term capital gains requires that an investment be held for more than one year before the investor is entitled to claim the 60% long-term capital gains deduction. Recent legislative initiatives have been proposed to reduce the holding period to 6 months or eliminate it totally. The rationale being advanced for these revisions is that a shortening of the holding period would increase capital market efficiency and reduce the lock-in effect on investors who do not desire to realize short term gains. However, these revisions may ultimately serve to disadvantage small enterprises. For example, if long term capital gains can be achieved with a six month investment in a relatively risk-free "blue chip" stock, why would an investor purchase equity securities of a small business when risks are higher, where there is less liquidity, and when realization of benefits may take years?

In the interest of rewarding realized gains accrued over an extended period, which is a primary purpose behind long-term capital gains treatment, consideration should be given to establishing a two-tiered holding period system with the capital gains deduction increasing to 80% if the small business investment is held for 5 years. Such a system would introduce a better balance between risk and reward.

The final recommendation that I wish to address requests that Congress pass legislation to provide that an individual investor with a substantial equity interest in a small business, who completely sells his shares in that business, may elect a one-time exclusion of a percentage/dollar amount of any long term-gain realized thereby, if such investor has attained the age of 65 and has held his investment for 10 consecutive years preceding the sale.

This recommendation will attract additional sources of capital for small businesses by offering the substantial investor the potential to earn large amounts of tax free income at an age when the investor may be considering retirement. The recommendation also recognizes that many small business persons who have expended tremendous resources building a business view the equity in that corporation as their prime source of retirement income. This recommendation is comparable to the provision in the Code which permits homeowers to exclude $125,000 of gain on the sale of a home if certain requirements are satisfied, such as attaining the age of 55 and the home having been the principal residence for a specified period of time prior to the sale.

It should be noted that there is a conspicuous absence of revenue estimates attributable to any or all of the tax proposals. The Executive Committee requested that the Treasury Department provide revenue estimates for several of the tax proposals discussed at the conference. However, the Treasury Department, due to its heavy workload attributable to the Tax Equity and Fiscal Responsibility Act of 1982 and other pending tax initiatives, was unable to produce the data in time for conference

consideration. In order that such statistics would be available, separate and apart from the Treasury Department, the Forum participants recommended the development of a small business data base. Such a data base would provide legislators, regulators, and commentators with the information necessary to better determine the needs of the small business community and assess the impact of legislative and regulatory initiatives on small business concerns.

Although I have not discussed the other tax recommendations developed at the Forum, I wish to point out that they all address issues of relative importance to the small business community and merit careful consideration and review by these and other appropriate Congressional Committees.

Thank you.

Representative NOWAK. Thank you very much. I think just a comment on your last statement. That followup is probably very, very important. When we learned of the forum, one of the things we wanted to do, of course, was to get the input so that it would not be merely a report on proceedings which was issued and sent to everybody who attended. That would be the last of the initiatives to consider as far as coming before any of the agencies that were affected, much less talking about the Congress where probably 60 to 70 percent of the changes, if they are going to be meaningful, will have to be made. I also agree that perhaps Treasury should have played a bigger role in trying to look at and comment to the participants who had specific ideas about any of the recommendations so they would be able to start their assessment right at that point in time instead of waiting perhaps a year or two.

So that, I think, could be made part of the next forum, and hopefully it will lead to a tighter and perhaps even more meaningful response from the participants to see the other side of all of these problems.

Let me, Mr. Glaser, ask you a couple of questions. When you talked about the general jobs tax credit, you were with the firm and your small business clients at that time. I wonder to what extent do you recall that general jobs tax credit used in the mid- or late-1970's and how extensive was it, and did you see any direct benefits?

Mr. GLASER. Not doing a detailed study on it, I can give you my perception of it. Basically, small businesses have trouble raising capital and in lieu of, say, raising another $100,000 to purchase a new piece of machinery that might eliminate five jobs, the businessman would hire additional employees and utilize the older equipment when the general jobs credit was available. They were more willing to go out and say, "I will not get this particular piece of machinery, however, I am going to hire some more people. Not only do I get the benefits of not having to lay out $100,000 currently——

Representative NOWAK. That they may not have.

Mr. GLASER. That they may not have, and most likely do not, but they get a jobs credit at the same time. I would say, also, from my perspective that the analogy was not just used for small businesses, there are some rather sizable businesses that are having some problems also that took advantage of the jobs credits.

Representative NOWAK. In terms of new startups, though, what have you found in the last year or two, what type of industries, what type of new clients are you now encountering?

Mr. GLASER. In our area, we are encountering more—I don't know if high technology is the right word to use——

Representative NOWAK. Service sector.

Mr. GLASER. Service-sector-type businesses and light manufacturing. They are industries that are beginning to spring up all over. In fact, there are currently many businessmen trying to buy small businesses or segments of businesses back from large corporations. If you remember, in the early 1970's, there was the big corporate acquisition kick of large companies acquiring the profitable small businesses. Many of those large businesses now are finding they do not have the wherewithal to really run these smaller segments, so they are trying to sell them back to the individual entrepreneur who can run them because he is there and managing them.

However, what is happening there, and there are quite a few of these situations, is that the people who want to buy it and, in many cases there are many employees trying to put a deal together, have troubles raising the capital. They know how to run the business, they can make the business perform well, but they do not have the initial capital to do such.

Representative NOWAK. Thank you.

Professor Stevenson, you mentioned plan assets, if the definition of labor could relax that in their regs, and that they could do inhouse. Do you think we would still have a problem and there would still be problems with encouraging pension fund managers to invest in small- or medium-sized firms?

Mr. STEVENSON. Yes; there is still the problem of basic conservativeness, the question of liquidity, and also the problem of the prudent person rules. However, by creating a form of security such as participating security, it would make it easier to pool, and therefore, to provide capital, not only to companies that are going to go public, but also to those that might never have a public market. The firms might yield very attractive returns over their life to investors. I think that one of the great pieces of wisdom in the proposal for the small business participating security is providing funds for people that are not natural targets of venture capital.

Representative NOWAK. I do, too.

Senator, do you have questions?

Senator D'AMATO. Thank you, Mr. Chairman, yes. I think it is very important and again I reiterate because I want the record to reflect my deep concern that we get Treasury's input in terms of that request that was made. As Mr. McNeish indicated, Treasury was requested to make available their estimates with respect to the various costs of the proposals and recommendations that came from this forum.

I will ask for those from this committee, that we go on record in addition requesting that information. I would ask that the executive committee of the forum reiterate its request because I think it is more than a matter that they just did not have it at the moment, rather, they are recalcitrant, reluctant, and unwilling to provide that information. That has been their style.

So, let the record speak for itself. I guess I can expect an audit or something for saying that.

Representative NOWAK. Senator, you get that every year automatically, you know.

Senator D'AMATO. Going on to the question with respect to the study of the Brookings Institute and the Birch study, Professor Stevenson, have you had an opportunity to review those two studies and do you have any thoughts in regard to them?

Mr. STEVENSON. I have had an opportunity to review Mr. Birch's reply to Brookings in which he has developed a snappy study called "The Small Business Share of Job Creation and Lessons Learned From the Use of the Longitudinal File." In the 33 pages, he has examined the techniques used by Brookings in their study of shorter period than in his original study. He took issue with many of the very important estimates which they use. Based on a reexamination of their data and the techniques they used for estimation, he believes that more careful estimates for that same period, using their same data, would show 70 percent of the jobs were created by small businesses, rather than the 39 percent which are Brookings estimates.

Thirty-nine percent is lower than his initial estimate over the longer period. This probably reflects the economic times of the period Brookings chose, but his analysis of the problems in Brookings' techniques sharply changed the data and the conclusion.

Senator D'AMATO. Do you have any thoughts with respect to Birch's analysis of the initial Brookings——

Mr. STEVENSON. I found it persuasive because in the Brookings study, a high percentage of the jobs they estimated for large businesses were employment and records that were either modified or manufactured in the process of estimation by Brookings. Approximately 29 million, and 85 million jobs they studied were in records that were modified. Without having a deep chance to look at the underlying data, his analysis of the potential sources of error in their estimates seem persuasive.

Senator D'AMATO. Mr. Chairman, I would simply like to thank you for being one of the catalysts for moving this joint committee in such a way that we will be able, hopefully, to make some recommendations to our respective committees and then go one step further and maybe in a rather unusual precedent, see that both Houses, in conjunction with some of these recommendations, move together; at least our committees. I was a bit surprised to learn that you have got that same problem that we have.

I thought only the Senate had the turf battles, you know, where Finance wants to do everything. My God, strike that from the record. No; but, you know, Big Brother—I guess we have Big Brother Finance over in the Senate and they rank supreme over every single aspect; you know everything is financed, so consequently you cannot act on anything unless you are on Finance.

I guess you have that with Ways and Means. After a while, they really get to believe it. If you take Ways and Means and Finance on both sides, and Treasury, why you could eliminate everybody else and look how much money we would save.

We could eliminate all the other agencies and all the other Congressmen and Senators and, my God, that would be a great windfall for the people. I don't think it would be too effective, I don't think it would help the employment situation much.

But anyway, Mr. Chairman, I want to pay particular regard to our staffs, to yourself, providing the impetus to bring us together

today, and I would be remiss if I did not say that we are very indebted to those who have participated, who have given of their time.

I look forward to us coming together, attempting to galvanize behind those areas of agreement, and I think we can agree on most of those recommendations, but particularly those where we have a very real chance to accomplish something.

I think that is important. Sometimes you look to accomplish everything and you miss the mark and accomplish little, if anything. But I think there are some very key points here that we can agree upon and that we might have an excellent opportunity of having enacted into law.

So, I would like to thank all of the participants today and say to my distinguished colleague from the northwest portions of our great State of New York who understands the necessity to get small business moving, to pick up some of the slack that will never be picked up in terms of the huge industrial steel plants and auto plants, and it is going to take the technological know-how, the drive, the dedication, the risk-taking the small business has provided this Nation, and we have got to give them that assist if we are going to get those unemployment rolls down and get people working and producing and generating taxes.

So, I think this was an outstanding hearing and I am looking forward to reviewing the testimony in depth at a later date, and hopefully, we can get some action on it.

Representative NOWAK. Senator, thank you very much. You know, in many ways, this is a unique situation where a Senator would come over to a House hearing, even though we have nicer quarters.

Senator D'AMATO. True, and bigger staffs.

Representative NOWAK. And bigger staffs. But we appreciate your participation in this, and I know it stems from your deep belief in the subject that we are discussing.

Maybe we have set a precedent in such a joint hearing, but I think it is one that perhaps should be taken advantage of more and more. Because if you start with some basic agreement and can reach a consensus, I think we could perhaps get a lot more accomplished than we can piecemeal by sending messages back and forth through the House floor and through the Senate floor and then not ever coming to real agreement on the passage, along with whichever administration may be in the White House at that time.

I think this has certainly been a good hearing. As you had mentioned, Senator, the participants have been outstanding. They not only know the subject, but I think they give us a base from which we can move and we can call on them in the future for their expert opinion on some of the things as we try, as you say, to galvanize and bring together a good, tight consensus so that we can actually accomplish our goal of putting together an incentive for small business.

I want to thank everybody for attending. This session is adjourned. Thank you.

[Whereupon, at 4:10 p.m., the subcommittees adjourned, to reconvene subject to call of the Chairs.]

APPENDIX

SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION

FINAL REPORT

U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

November 1982

Introductory Statement from the Chairman of the Executive Committee

The following comprises the Final Report of the first Annual SEC Government-Business Forum on Small Business Capital Formation. As described in detail in the text of the Report, the Forum grows out of the provisions of Section 503 of the Small Business Investment Incentive Act of 1980. Among other things, this legislation directs the SEC to conduct an Annual Government-Business Forum to review the current status of problems and programs relating to small business capital formation and to transmit to Congress a summary of the Forum proceedings together with any findings or recommendations.

I wish to emphasize that the Commission has not sought to influence the substance of the findings and recommendations in any way nor has it taken a position on any particular recommendation at this time. The governing body of the Forum was an Executive Committee comprised of designees from various private sector business organizations and key government agencies which administer programs affecting small business capital formation. The recommendations reflect the majority views of the 176 Forum participants who met in Washington for a three-day period from September 23 through September 25, 1982 to develop and debate proposals designed to enhance the ability of small business to obtain capital. Participants were selected on the basis of their interest and expertise and included many small business persons from throughout the country. In addition, Forum participants included broker-dealers, government

officials, accountants, academicians, attorneys, bankers, venture capital investors and others involved in small business capital formation. Accordingly, the recommendations adopted do not represent the view of any one individual, association, economic interest, agency or organization.

Small business is a vital segment of our national economy. Various studies indicate the importance of small business establishments in the creation of new jobs and important technological innovations in the United States. In this context, the efforts of the Forum take on particular significance. I am hopeful that in the coming months Congress and the various government agencies whose programs would be affected by the Forum's recommendations will give them careful consideration.

I am grateful to Chairman Shad for designating me Chairman of the Executive Committee and thereby enabling me to participate in this worthwhile endeavor. The success of this year's Forum is attributable to the diligent efforts and considerable contributions of many individuals and organizations. Government agencies, including the Small Business Administration, Department of the Treasury, Department of Commerce, and the Federal Reserve Board made major contributions through representation on the Executive Committee, and by providing resource materials and expertise. The professional and clerical staff of the SEC's Office of Small Business Policy worked tirelessly and effectively in performing the staff work of the Forum. Special recognition should be extended to Mary E.T. Beach, Associate Director in the Division of Corporation Finance, and Paul A. Belvin, Chief of the Office of Small Business Policy, both of whom

provided invaluable insight, guidance and direction in planning the Forum.

While acknowledging the significant contribution of government officials to the work of the Forum, it is clear that the key ingredient in the success of this Forum was the unselfish and effective work of the many private sector participants who gave freely of their time and expertise, came to Washington at their own expense and have dedicated themselves to enhancing small business capital formation. It is the entrepreneurial spirit of people like these that makes our economic system function, and their willingness to participate in the public policy process that gives our democratic form of government its viability and its meaning.

JOHN R. EVANS
COMMISSIONER
U. S. SECURITIES AND EXCHANGE COMMISSION

Members of the Executive Committee

Chairman - Commissioner John R. Evans
Securities and Exchange Commission

Mary E. T. Beach, Associate Director, Division of Corporation Finance, Securities and Exchange Commission.

* Thomas Bennett, Senior Vice President, Stillwater National Bank & Trust Company.

Kenneth V. Bialkin, Chairman, Section of Corporation, Banking and Business Law, American Bar Association.

* Herb Braun, Ernst & Whinney.

Samuel A. Derieux, Former President, American Institute of Certified Public Accountants.

* Jerry Feigen, Associate Advocate for Capital Formation and Venture Capital, Small Business Administration.

John Fitch, Vice President, Government Relations, National Association of Wholesaler Distributors.

Robert E. Greer, Vice President, Marketing Research and Planning, American Stock Exchange.

Daniel Gregory, Secretary, National Venture Capital Association.

* George Groff, Deloitte Haskins & Sells.

* Steven Gurgovits, Executive Vice President, American Bankers Association.

Glendon R. Hildebrand, Assistant Director, Research & Technical Activities Division, Financial Accounting Standards Board.

Mary Jo Jacobi, Director, Office of Business Liaison, Department of Commerce.

* Stewart Karlinsky, Professor, School of Accounting, University of Southern California.

John Kelly, Assistant Secretary for Public Liaison and Consumer Affairs, Department of the Treasury.

* Thomas P. Kerester, Coopers & Lybrand.

Elbert Mackey, Chairman, Subcommittee on Small Business Financing, North American Securities Administrators Association.

Peter McNeish, Executive Vice President, National Association of Small Business Investment Companies.

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Douglas F. Parillo, Vice President, Department of Policy Research, National Association of Securities Dealers.

Lee B. Spencer, Jr., Director, Division of Corporation Finance, Securities and Exchange Commission.

Herb Spira, Tax Consultant, National Small Business Association.

Eleanor Stockwell, Senior Deputy Associate Director, Division of Research and Statistics, Board of Governors of the Federal Reserve System.

Frank Swain, Chief Counsel for Advocacy, Small Business Administration.

William Taylor, Chairman, Small Business Committee, American Bar Association.

* Linda Wertheimer, Chairman, Subcommittee on Partnerships, Trusts, and Unincorporated Associations, American Bar Association.

Ernest R. Widmann, Vice-President, Financial Analyst Federation.

David Hart Wunder, President, North American Securities Administrators.

* Designates Members of an Executive Committee Task Force.

Forum Staff

Paul A. Belvin, Staff Director

Matthew R. Schneider, Senior Special Counsel

H. Steven Holtzman, Special Counsel

Daniel J. Abdun-Nabi, Staff Counsel

Betsy C. Goodell, Staff Counsel

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I. FORUM RECOMMENDATIONS

A. Developing Incentives to Institutional Investors And Others To Invest In Small Business

Recommendation (1) Congress should amend the Internal Revenue Code to provide for a "Small Business Participating Security", a hybrid form of security that would offer both a fixed rate of interest and a percentage of profit to the investors. Such a security would include such tax features as:

A. Capital gains treatment on the investors' profits;

B. Deductibility by the small business of both the profits and interest paid out by the business; and

C. An investment tax credit to the investor for such investment.

Recommendation (2) Congress should create a federally chartered, privately managed "Capital Bank" to provide a secure and stable source of continued funding for the Small Business Investment Company ("SBIC") program. A "Capital Bank" could have the following principal characteristics:

A. The Bank would be initially capitalized by the U.S. Treasury at the level of $100 million. This would represent a one-time, non-recurring investment by the federal government.

B. The Treasury investment would be retired over time out of profits earned by the Bank. The Bank's income would be derived from spreads on its loans, investment income and service fees.

C. SBICs would be obligated to purchase "participating" stock in the Bank.

D. The Bank would be authorized to issue its own securities (notes, debentures, stock) in conventional financial markets. These would be tax-exempt, backed by the SBIC debentures which the Bank had purchased and would be insured against loss by the Bank. The Bank would also be authorized to pool the SBIC debentures it purchased and sell participating interests in those pools. The pools would be structured so as to fall outside of the definition of an "investment company" under the Investment Company Act of 1940. The participating interests would have similar tax-exempt status and insured or guaranteed characteristics.

E. On a phased basis, the Bank would become an institution owned by persons in the private sector.

Recommendation (3) The $35 million ceiling on leverage to an SBIC should be removed.

Recommendation (4) Congress should amend Subchapter M of the Internal Revenue Code to provide conduit tax treatment for shareholders of business development companies.

B. Relaxing ERISA And Similar Regulatory Restrictions To Encourage Investment in Small Business

Recommendation (1) The Department of Labor, in conjunction with other appropriate government agencies, should disseminate to the fullest extent possible its position that investments by employee plans in smaller companies are not per se imprudent.

Recommendation (2) The Department of Labor should adopt a definition of the term "plan assets" under ERISA to permit venture capital managers to continue to invest pension plan funds without qualifying as plan fiduciaries and without venture pool assets qualifying as plan assets.

Recommendation (3) States should be encouraged to revise their public pension laws to permit investment of public pension assets in accordance with a flexibile prudent person standard applied to the portfolio as a whole.

Recommendation (4) Pension funds and other institutions should be encouraged to utilize intermediaries experienced in small business financing in order to facilitate investment in small business.

C. Reducing Costs Associated With Securities Regulation

Recommendation (1) The SEC should exercise its jurisdiction:

> A. Under §3(b) of the Securities Act to determine that no federal interest exists in offerings of less than $5 million by "Small Business Concerns" not required to be registered under §12 of the Securities Exchange Act at the time of the offering. "Small Business Concerns" should be defined to exclude (i) divisions or subsidiaries of non-exempt companies and (ii) tax shelter type offerings.
>
> B. To encourage a change in §12(g), by law or regulation, to increase materially the threshold criteria for registration, using net worth (shareholders' equity) as the test [suggested $5 million net worth and 2,000 shareholders].

Recommendation (2) The SEC should adjust the periodic reporting requirements for small businesses with a view toward simplification where appropriate. In particular, the SEC is urged to adopt a rule which permits an issuer which is neither listed on an exchange nor traded on the National Association of Securities Dealers Automatic Quotation System ("NASDAQ") to satisfy the Exchange Act reporting and proxy requirements if the issuer makes available to its security holders and files with the SEC:

A. Within 90 days after the end of its fiscal year, financial statements audited in accordance with GAAP for the last two fiscal years; and

B. 45 days after the end of each of its first three fiscal quarters, an unaudited financial statement in the same form as required for a 10-Q report.

Recommendation (3) The SEC should consider amending Form S-18 to permit its use for offerings of securities up to $10 million.

Recommendation (4) The Financial Accounting Standards Board ("FASB") and other interested parties should identify the critical aspects of financial information which lenders to and investors in small business need for investment and credit decisions. Those parties should insure that requirements for financial statements and disclosures are responsive to those needs, subject to the cost-benefit trade-offs of providing information.

Recommendation (5) The SEC should introduce the concept of "substantial good faith compliance in all material respects" into the exemptive scheme by amendments of existing rules and/or adoption of a new rule or rules to provide that substantial good faith compliance in all material respects will satisfy the requirements of such exemptions and that no §12(1) liability will attach where non-compliance is both innocent and immaterial.

Recommendation (6) The SEC should amend Rule 144 to allow the sale of securities thereunder by non-affiliates after a three year period without further regulatory requirements.

D. Uniform Federal-State Securities Regulation

Recommendation: The state securities administrators, through the North American Securities Administrators Association ("NASAA"), should develop and each state should adopt:

A. A uniform exemption at some level similar to Rule 504 of Regulation D; and

B. Uniform limited offering exemptions identical to Rules 505 and 506 of Regulation D.

E. Changes In Corporate Tax Rates And Brackets To Assist Small Business Capital Formation And Retention

Recommendation (1) Congress should modify the present corporate income tax rate and bracket structure. The highest corporate tax rate should apply to corporate taxable income of over $500,000 as contrasted with $100,000 at present. The lowest tax bracket should be increased substantially from its present $25,000 level, without increasing the 15% rate applicable after 1982. Other graduated tax brackets below $500,000 should be established.

Recommendation (2) Congress should give consideration to the following:

A. That small corporations be entitled to income average in the same manner individuals income average,

B. That the accumulated earnings tax exemption be raised from its present level of $250,000,

C. That dividends be deductible, to some extent, provided that they are reinvested in small business, and

D. That a small business data base be developed so that the significance of small business to the U.S. economy and the effect of proposed tax changes can be more accurately determined.

F. Changes In The Tax Treatment Of Capital Gains To Provide A Stimulus To Capital Formation, Particularly For Smaller Businesses

Recommendation (1) Congress should amend the Internal Revenue Code to provide an investment tax credit, equal to 10% of funds invested, for investment in a "Qualified Small Business Investment" (QSBI).

1. Such credit would not be available for any investment if the source of such funds is the sale or other liquidation of a prior QSBI in a transaction occurring less than a specified number of years prior to the date of the new investment;

2. The capital gains tax otherwise payable with respect to any investment liquidations, upon election, shall be deferred on the portion of the capital funds which are reinvested in a QSBI within a certain period of time from the date of the transaction producing such capital gain. The tax may be deferred until a subsequent QSBI investment is liquidated, or until the date of liquidation of the last QSBI investment in a chain of transactions; and

3. A "Qualified Small Business Investment" would be:

   (a) An equity security or debt instrument issued by a Small Business Investment Company, Business Development Company, or a small business as determined by reference to the SBA small business size standards for SBIC investments;

   (b) An equity security or debt instrument which does not permit the investor to require the repayment thereof sooner than five years after the date of the investment; provided that a debt instrument may provide for a minimum five year amortization; and

   (c) In the case of a debt instrument, one which provides for interest not to exceed the then current federal financing bank rate.

Recommendation (2) Congress should amend the Internal Revenue Code to provide that after holding an equity or equity-type investment made directly in a small business for more than five years, the seller of such an investment would be entitled to exclude 80% of any gain realized on such investment.

Recommendation (3) Congress should amend the Internal Revenue Code to provide that any long-term capital gain realized upon the sale of an equity or equity-type investment made directly in a small business (as defined by the SBA) shall be taxed to a corporation at the maximum effective rate applicable to an individual for an identical investment.

Recommendation (4) Congress should amend the Internal Revenue Code to eliminate the ($50,000/100,000) limitation on loss deductions for §1244 small business stock. Corporations should be eligible for §1244 ordinary loss treatment. The stock limitation for §1244 corporations should be increased from $1 million to $5 million. Corporations and individuals should be allowed to take ordinary loss deductions on all instruments (i.e., debt, preferred stock and guarantees, as well as common stock) used to invest in §1244 corporations.

Recommendation (5) Congress should pass legislation providing that the deductibility of interest paid on loans incurred to invest directly in small businesses (as defined by SBA) should be unlimited.

Recommendation (6) Congress should pass legislation providing that an individual investor with a substantial equity in a small business, who completely sells his shares in the business, may elect a one time exclusion of a percentage/dollar amount of any long-term capital gain realized thereby, if such investor has attained the age of 65, and has held his investment for 10 consecutive years preceding the sale.

G. Additional Tax Modifications To Assist Small Business Capital Formation And Retention

Recommendation (1) (§385 Debt/Equity Regulation) Section 385 of the Internal Revenue Code should be repealed and existing case law and guidelines should be used to distinguish debt and equity for tax purposes. However, should Congress, for policy reasons, determine that repeal is undesirable, the Treasury Department should be encouraged to adopt broad safe-harbors for small businesses under the §385 debt-equity regulations, which are easy to understand and apply, including:

1. An exemption from the regulations for corporations with less than $1 million in debt held by shareholders;

2. A shareholder debt to equity ratio safe-harbor of 5 to 1, replacing the 3 to 1 safe-harbor in previous versions of the regulations;

3. Exemption from regulations for corporations during the first five years of their existence;

4. Use of market value rather than book value of corporate assets for purposes of applying the safe-harbor, at the election of the corporation or instrument holder; and

5. Review of the application of the regulations to investments with conversion features.

Recommendation (2) (Subchapter S) Congress should (in addition to H.R. 6055) continue to study liberalization of Subchapter S, including the adoption of legislation

1. Allowing more than one class of stock for Subchapter S corporations·
2. Allowing partnerships, corporations, and trusts to be shareholders of Subchapter S corporations;
3. Increasing the number of shareholders in a Subchapter S corporation to as many as 100·
4. Allowing Subchapter S corporations to form DISCs· and
5. Increasing the number of days during the taxable year for electing Subchapter S to as many as 240 days.

Recommendation (3) (Jobs Tax Credit) Congress should restore permanently the general jobs tax credit as originally enacted in the Tax Reduction and Simplification Act of 1977.

Recommendation (4) (Accounting Methods) Congress should amend the Internal Revenue Code to allow businesses with less than $3,000,000 in annual sales to elect for tax purposes either the cash receipts and disbursements method or the accrual method of accounting.

Recommendation (5) (Incentive Stock Option) Congress should revise the Incentive Stock Option provisions of §422A of the Internal Revenue Code including the following·

1. Increase the §422A(b)(8) ceiling limitation of $100,000 in order to permit appropriate equity opportunity necessary to attract key employees capable of contributing to the growth of an emerging company.
2. Eliminate the sequential exercise rule prescribed in §422A(b)(7).

3. Modify the Tax Equity and Fiscal Responsibility Act of 1982 in order that the exercise of an Incentive Stock Option will not give rise to an item of tax preference under the alternative minimum tax provisions scheduled to go into effect December 30, 1982.

H. Federal Small Business Credit Assistance Programs

Recommendation (1) Congress should authorize SBA to permit revolving credit arrangements and other normal commercial loan accomodations in connection with small business loan guarantees.

Recommendation (2) Congress should raise SBA's loan guarantee limit to $1,000,000.

Recommendation (3) Congress should:

A. Increase the SBA loan guarantee authority; and

B. Expand the SBIC and 503 programs.

Recommendation (4) The SBA should:

A. Reduce extensive paper work and time delays, and simplify complex approval procedures which have characterized the loan guarantee program in the past.

B. Accelerate and expand to the extent possible the Certified Lenders Programs and non-bank lending programs.

Recommendation (5) The SBA should permit interest rates on guaranteed loans to be based on local primes or indices.

Recommendation (6) A survey of commercial banks and small business attitudes towards the SBA loan guarantee program should be conducted in order to remove impediments to increase utilization of the program.

Recommendation (7) The SBA should:

A. Support the SBA 503 program with sufficient SBA staff and debenture guarantee authority to meet loan demands of certified development companies;

B. Attempt to develop greater communication with its certified development companies and the National Association of Development Companies; and

C. Permit a ten-year debenture as well as 15-, 20-, and 25 year debentures.

Recommendation (8) The current tax exempt status of small business industrial revenue bonds (IRBs) should be preserved and the sunsetting of IRB tax benefits is opposed. Policy should be changed to permit SBA and other agencies to participate with industrial revenue bonds in the same project. To enhance small business utilization of IRBs, the Internal Revenue Service should allow packaging of small IRB issues into one large issue.

Recommendation (9) Any legislation in connection with the financial industry should consider the needs of the small and medium sized banks which finance small business.

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II. DEVELOPMENT OF THE FORUM

A. Introduction

The importance of small businesses as a vital productive and employment growth segment of the economy has been well documented. Despite the significance of small businesses to the economy, they have traditionally faced critical capital needs. Those needs have been exacerbated by economic trends over the past several years which have featured high interest rates and double-digit inflation. It is generally recognized that small businesses bear the greatest burden in any credit squeeze. This is reflected in record rates of court-filed bankruptcies that are occurring at a pace that continues to escalate. 1/

In recognition of the importance of small businesses to the economy and the continuing capital formation problems that small businesses encounter, Congress, in the Small Business Investment Incentive Act of 1980, 2/ directed the Securities and Exchange Commission to conduct an annual Government-Business Forum (the "Forum") ". . . to review the current status of problems and programs relating to small business capital formation." 3/ Congress directed that participation in the Forum should

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1/ Based on statistics compiled by the Office of Advocacy of the Small Business Administration from Dun & Bradstreet, Inc., The Business Failure Record and unpublished data courtesy U.S. Administrative Office of Courts, Statistical Analysis and Report Division. See also The State of Small Business: A Report of the President, Transmitted to the Congress March 1982, pp. 77-83.

2/ Pub. L. No. 96-477 (October 21, 1980).

3/ Id. §503.

include other federal agencies, such as the Department of the Treasury, the Board of Governors of the Federal Reserve System, the Small Business Administration, organizations representing State securities commissioners and leading small business and professional organizations concerned with capital formation.

This is the first year that the Forum has been conducted. An Executive Committee was formed in March 1982. That Committee was comprised of representatives from government agencies and a number of private sector organizations in accordance with the Congressional guidelines. Securities and Exchange Commission Chairman John S.R. Shad designated Commissioner John R. Evans to serve as Chairman of the Executive Committee. The Executive Committee, at its first meeting on April 20, 1982, approved the following objectives for the Forum:

1. To identify specific problems encountered by small businesses in their attempts to raise capital.

2. To prepare discussion papers which contain a thorough analysis of, and present various solutions to, each of the specific problems.

3. To invite small business persons, professionals who represent them and other interested members of the public to attend an open forum to be held in the fall of 1982 to consider the discussion papers and the alternative solutions presented therein, and to develop recommendations to be sent to Congress or to appropriate government agencies as to actions that could be taken to improve the climate for capital formation.

B. Small Business Survey

Although generally familiar with the problems confronting small businesses, the Executive Committee desired additional input as to the most useful measures that could be undertaken to encourage capital formation. To obtain this input, the SEC and Financial Reporting Institute of the University of Southern California sponsored a survey to determine the views of executives of smaller businesses. The survey was conducted by Professor Jerry L. Arnold, the Institute director. 4/

The survey set forth four proposals under each of the four broad categories as follows:

1. Income Taxation

a. Reduction in corporate tax rates

b. Relief of the double-taxation of corporate income

c. Further changes in the rate or other tax treatment of capital gains

d. Tax incentives for the purchase of specified securities issued by small businesses

2. Securing Credit From Banks

a. Reducing compensating balance and/or collateral requirements

b. Relaxing restrictive covenants on loan agreements

c. Reduction of interest rates

d. Lengthening of repayment periods

4/ A detailed report on the survey prepared by Professor Arnold, including an analysis of survey results, is attached as Exhibit A.

3. Access to Financial Institutions

a. Incentives to stockbroker/dealers to assist small businesses both in issuing securities and maintaining an after-market

b. Relaxing the ERISA restrictions to encourage investment in small businesses

c. Incentives to encourage local bank growth and development

d. Incentives to institutional investors to invest in small businesses

4. Raising Capital

a. Reducing corporate liability associated with issuance of securities

b. Reducing cost of complying with securities regulations

c. Reducing information requirements for present and prospective shareholders

d. Reducing complexities caused by different requirements of Federal/State authorities

These categories and potential actions were selected as a result of several meetings attended by Professor Arnold and members of the Executive Committee.

The individuals participating in the study were asked to rank the measures in each category in the order in which they believed the actions would encourage capital formation. The most helpful step was to be ranked first and the least helpful fourth.

Overall Results

The overall rankings of responses by category are presented in Table 1 below. These rankings were based upon the percent of number 1 ranks assigned to each potential step. Since some participants did not

assign a rank to each step, the number actually ranking each step ranged from a minimum of one hundred ninety one (191) to a maximum of two-hundred-two (202). To account for these differences, the percentages have been rounded off.

Table 1
Ranking of Possible Steps to Assist Capital Formation
Based upon Relative % of Number 1 Ranks Assigned By Category
Number of Respondents = 207*

Rank	Income Taxation	% Number 1 Ranks Assigned
1.	Relief of the double-taxation of corporate income	37
2.	Reduction in corporate tax rates	35
3.	Tax incentives for the purchase of specified securities issued by small businesses	21
4.	Further changes in the rate or other tax treatment of capital gains	7
	Total	100 %

Rank	Securing Credit from Banks	% Number 1 Ranks Assigned
1.	Reduction of interest rates	93
2.	Reducing compensating balance and/or collateral requirements	4
3.	Lengthening of repayment periods	3
4.	Relaxing restrictive covenants on loan agreements	0
	Total	100

*As noted previously, less than 207 actually ranked each step.

Rank	Access To Financial Institutions	% Number 1 Ranks Assigned
1.	Incentives to institutional investors to invest in small businesses	39
2.	Incentives to encourage local bank growth and development	24
3.	Relaxing the ERISA restrictions to encourage investment in small businesses	20
4.	Incentives to stockbroker/dealers to assist small businesses both in issuing securities and maintaining an after-market	17
	Total	100 %

Rank	Raising Capital	% Number 1 Ranks Assigned
1.	Reducing complexities caused by different requirements of Federal/State authorities	45
2.	Reducing cost of complying with securities regulations	35
3.	Reducing corporate liability associated with issuance of securities	11
4.	Reducing information requirements for present and prospective shareholders	9
	Total	100 %

C. Issue Selection

The Executive Committee formed four Task Forces to develop discussion papers and proposals in each of the four areas covered by the questionnaire. Each Task Force was comprised of four to five members of the Executive Committee and other individuals selected by each Task Force on the basis of their expertise in the area being considered. The Task Forces developed eight discussion papers addressing the following issues:

1. Developing incentives to institutional investors and others to invest in small business.

2. Relaxing ERISA and similar regulatory restrictions to encourage investment in small business.

3. Reducing costs associated with securities regulation.

4. Uniform Federal-State securities regulation.

5. Adjustment of corporate tax rates and brackets to reflect the internal capital raising needs of small business.

6. Changes in the tax treatment of capital gains to provide a stimulus to capital formation, particularly for smaller businesses.

7. Additional tax modifications to assist small business capital formation and retention.

8. Revisions in the Small Business Administration programs to assist the financing of small business.

The issue papers developed for the Forum reflect the considered efforts of each of the Task Forces in evaluating the survey results and selecting appropriate topics and alternative solutions. They were not intended to cover every problem within a particular subject area. Also, the proposals were not endorsed by the Task Forces but represented areas that the Task Forces believed would be appropriate for discussion at the Forum. Forum participants were free to raise new or related issues.

Although each Task Force attempted to develop discussion papers and proposals for the two issues ranked most important by the survey response, this was not always appropriate or desirable. For example, the double taxation of corporate income was not selected as an issue for the Forum for two primary reasons. First, many small businesses normally retain all earnings in order to internally finance growth. Also, further contact

by the Institute, at the request of the Tax Task Force, with randomly selected survey respondents indicated a significant degree of uncertainty regarding the nature of the issue.

The subject of interest rates also was not selected for treatment as a discussion issue at the Forum. The Executive Committee and the Credit Task Force recognized that high interest rates represent one of the most significant problems facing small businesses today. However, it was their judgment that the subject of interest rates and the various solutions that have been proposed, such as revisions of Federal Reserve Board monetary policy, removal of the independence of the Board and passage of a balanced budget Constitutional amendment, are of such magnitude and political significance that their discussion at the Forum might have precluded discussion of the other issues selected. Finally, it was felt that long term relief from the interest rate problem could be benefited by the issues selected which are designed to facilitate small business access to permanent capital.

Although not selected as one of the eight discussion issues, the interest rate question was developed in an alternative format. The Honorable Lyle E. Gramley, a member of the Board of Governors of the Federal Reserve addressed the interest rate problem at the luncheon on Thursday, September 23, 1982. Also, a substantial question and answer period followed Governor Gramley's remarks.

D. Conduct of the Forum

The discussion group format of the Forum, described in detail below, was designed to bring together and encourage the free flow of information and ideas among small businessmen, the professionals that represent them, and representatives of federal regulatory agencies. The Executive Committee determined that in order to obtain maximum input from the small business sector, small business participation in the Forum should approximate 50%. Every effort was made to achieve that benchmark. All small business persons indicating an interest in participating were invited, while members of the Executive Committee actively solicited additional prospects. However, the acceptance rate among the small business invitees was not as high as among some of the other groups. Accordingly, small businessmen comprised approximately 30% of the participants with the remainder being made up of attorneys, accountants, academicians, venture capital investors, financial analysts, bankers, economists, financial advisors, broker/dealers and government officials.

The Forum was held over a two and one-half day period, September 23-25, 1982, and was conducted as follows:

Day 1 and Day 2 (morning) - Participants met briefly in a session for opening remarks and announcements by Forum Executive Committee Chairman, Commissioner John R. Evans. SEC Chairman John S.R. Shad delivered the keynote remarks. 5/ Chairman Shad, in his remarks, stated the purpose of

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5/ A copy of the remarks delivered by Chairman Shad are attached as Exhibit B.

the Forum was "to illuminate small business capital formation problems and evolve practical solutions." Recognizing that small businesses are of major importance to the national economy, he called attention to the burdens national policies have had on capital formation and to the need for changes to reverse the decline in the United States' relative rate of capital formation among industrialized nations.

Also discussed at this opening session was The Report on a Survey Conducted for the Government-Business Forum. This report, which was prepared by Jerry L. Arnold, Associate Professor and Director of the SEC and Financial Reporting Institute, University of Southern California, has been summarized above.

After the general session, participants met in eleven discussion groups of approximately sixteen persons. Each group considered all of the recommendations in the eight issue papers which had been furnished to participants prior to the Forum. Participants also had an opportunity to raise new proposals. A minimum of two discussion leaders were responsible for leading the discussion on each major issue. Their goal was to facilitate an informed discussion of the issues so that each participant could develop his views and comment on the proposals. The comments of the discussion groups were used to frame the recommendations during the Day 2 afternoon sessions.

The Day 1 luncheon speaker was the Honorable Lyle E. Gramley, member of the Board of Governors of the Federal Reserve. This presentation focused on the subject of interest rates and was followed by an active question and answer session open to all participants.

The Day 2 luncheon speaker was the Honorable Henry J. Nowak, Chairman, Small Business Subcommittee on Tax, Access to Capital and Business Opportunities, U.S. House of Representatives. Congressman Nowak's remarks focused on legislative matters before Congress which might affect small business and the ability of small businesses to more effectively seek legislative solutions to capital formation problems.

Day 2 (Afternoon) - The Forum's Major Issues Drafting Sessions were held during the afternoon of the second day. In these sessions, all of the discussion leaders for each major issue met together to consider the views of their discussion groups and to establish recommendations with respect to their particular issue. While the drafting sessions generally focused on the views expressed in the discussion groups, the development of new proposals at the drafting session was permitted. A drafting session did not have to be unanimous in its opinion regarding suggested proposals and it could submit proposals supported by a strong minority. Contradictory proposals were allowed in order to provide the Forum participants with a choice of options. Finally, the proposals were not required to be ranked in any order of importance or priority.

Final proposals were developed and drafted for presentation at the Day 3 General Session. Each major issue group designated a representative(s) to present its recommendations and supporting statement.

Day 3 (Morning) - This session was open to all members of the public and press. All participants met in a plenary session at which the proposals for each major issue were presented along with a three minute explanation. Other participants could comment on the proposals. In

order to ensure consideration of all the proposals individual comments were limited to one minute within the allotted ten minute comment period per proposal. Modifications of the proposals were permitted but proposals not discussed by the major issue drafting groups could not be introduced. To be adopted, a proposal had to receive a majority of the votes cast.

A total of forty-four proposals from the eight major issue groups were presented for consideration at the plenary session. These proposals consisted of both majority and minority reports coming out of the previous day's drafting sessions. Thirty-seven proposals, including amended and dissenting or minority proposals, were adopted by the Forum. Eight proposals were defeated. One proposal received a tie vote. The disparity between the number of proposals presented and the number of proposals adopted or defeated is due to some proposals which, although defeated, were also conditionally approved as an alternative to an adopted proposal. In other instances, proposals overlapped with each other and were, therefore, merged. The recommendations developed by the Forum were not ranked in order of importance. 6/

6/ A transcript of the plenary session may be obtained by contacting the SEC Office of Small Business Policy.

III. DISCUSSION OF FORUM RECOMMENDATIONS

A. DEVELOPING INCENTIVES TO INSTITUTIONAL INVESTORS AND OTHERS TO INVEST IN SMALL BUSINESS

1. Statement of the Issue

Smaller companies traditionally have experienced difficulty in attracting funds from institutions and other investors. Insurance company, pension, investment company and bank trust department funds that amount to hundreds of billions of dollars could be utilized to substantially increase the amount of funds that are made available to small business. For a variety of reasons, however, institutional investors have tended to overlook small business investment opportunities and concentrate their assets with large companies. Non-institutional investors, including individuals, have not invested in small businesses for many of the same reasons.

2. Background

It must be recognized that the barriers to enhanced investment in small business are due, in some part, to a number of structural characteristics of small business rather than to legislative or regulatory obstacles that inhibit such investment. These structural characteristics, some of which are set forth below, relate to operational methods, size constraints and the degree of economic risk associated with many small businesses.

Investors may encounter difficulty in locating information on unlisted companies since financial data may not be made publicly available by a privately-held company. Adequate information on small listed companies also may not be readily obtainable from investment professionals inasmuch as research by financial analysts traditionally has been concentrated on larger companies.

Small and new business investment opportunities may carry substantial financial risk. It is generally recognized that long-term survival rates for new businesses are quite low. In addition, established small businesses may become high risk investments as they attempt to expand a current line of business or diversify into a new area.

Small business securities may not be easily marketable. Prices may be volatile, and demand may be limited or nonexistent, especially for securities of unlisted companies. Investors in small business also may have to forego dividends in exchange for long-term appreciation in the value of their securities.

Institutions, in particular, may be reluctant to invest in small business due to economies of scale. It may be economically more efficient for an institution to purchase shares of larger companies. For example, a number of small businesses may not be able to absorb the large investments that can be made through the purchase of the securities of a major company listed on an exchange. Institutions also can purchase shares of large companies in a more liquid secondary market than exists for smaller firms while incurring lower transaction and research costs.

Although some financing problems resulting from the structure of small businesses may persist, more effort is needed to attract both institutional and other investors to invest in small business. In addition, many of the factors that inhibit investments in small business can be minimized through the development of investment vehicles specifically designed for small business.

3. Recommendations

Recommendation 1 - A "Small Business Participating Security," a hybrid form of security that would offer both a fixed rate of interest and a percentage of profit to the investors, should be adopted. Such a security would include such tax features as:

A. Capital gains treatment on the investors' profits;

B. Deductibility by the small business of both the profits and interest paid out on the securities; and

C. An investment tax credit to the investor for such investment.

The Small Business Participating Security ("SBPS") could help to satisfy the financing needs of small companies by attracting new investors to the area of small business. 7/ The SBPS proposals that have been suggested contain a number of similar features that generally are as follows:

7/ The SBPS concept was originated by William D. Barth, Director of Small Business Practice at Arthur Andersen & Co. Both the White House Conference on Small Business and the Homestead Small Business Tax Conference endorsed versions of the SBPS in 1980. Since that time, a number of SBPS proposals have been submitted for Congressional consideration. Most recently, legislation that would enact the SBPS concept has been introduced in the 97th Congress by Representatives Eckart (H.R. 4015) and Marriott (H.R. 5078) and by Senator Weicker (S. 360). Hearings have not been held on the bills, and it is anticipated that there will not be any further Congressional action on them until the 98th Congress is convened in January. Nevertheless, support for the SBPS has continued to increase. H.R. 4015 received the support of 60 co-sponsors, and in May 1982, Small Business United, a national coalition of regional, state and metropolitan small business associations, endorsed the SBPS concept as one of its major legislative priorities.

a. The SBPS could be a general or secured obligation of the company. It would pay a stated rate of interest that would be not less than a standard rate of interest specified by the Department of the Treasury (currently 6 percent) or a rate negotiated by the parties (but not less than 6 percent). The SBPS would also provide for the payment of a share of the total earnings, preferably net earnings, of the issuer. This would ensure that the owners of the business could obtain investors without having to transfer an equity interest in the business to an outsider.

b. The small business entrepreneur would be able to deduct interest payments and amounts paid as a share of earnings as a business expense. The stated interest received by the investor would be taxable to the investor as ordinary income. The amount paid as a distribution of a share of the company's earnings would be taxable at the preferential long-term capital gains rate. An SBPS would be treated as Section 1244 stock, and therefore, an individual investor would generally treat a loss on an SBPS as an ordinary loss.

c. The particular terms of the SBPS would be determined by the parties in accordance with the prevailing market. The SBPS would have a fixed maturity date, and voting and conversion rights would not be available. The SBPS could be a self-executing instrument (i.e., there would not be any need for government approvals, permits or filings).

d. The SBPS also could provide an investment tax credit to the investor. The nature of such a tax credit varies among the different proposals. 8/

8/ Representative Marriott has proposed an investment tax credit of 20 percent of the amount of the SBPS or $20,000, whichever is less. The limit would be $40,000 in the case of a joint return. Benefits would be 50 percent higher in the case of minority or disadvantaged businesses. Senator Weicker previously proposed an investment tax credit not to exceed $5,000 or $10,000, in the case of a joint return. Both provisions provide for a carryover of an excess credit for up to seven years. A credit would not be allowed where the taxpayer is a related party to the company issuing the SBPS. A taxpayer would be a related party if he has more than a 10 percent interest in a business. Credit is not given for the amount of an SBPS acquired by a taxpayer from a small business to the extent that such small business acquires an SBPS from the taxpayer. A tax credit would not be allowed if the SBPS is disposed of prior to being held for one year. If the SBPS is disposed of after being held for more than one year but before the maturity date, the original tax credit would be recaptured in proportion to the length of time remaining to the maturity date.

e. The SBPS could provide for a specific redemption date. The issuing company would pay a premium for the use of the capital for the period of its use. The SBPS would differ in this respect from stock warrants and rights that, as a result of the shares issued pursuant to their terms, effectively participate in earnings after the company has experienced its critical need for funds and repaid them. It may be, however, that it would be more advantageous to an investor to be able to negotiate the period during which he would participate in the company's earnings. This flexibility could help to offset some of the risk to the investor.

f. The proposals differ in the size of the company that would be eligible to benefit from the SBPS. 9/ All of the proposals limit the face amount of outstanding SBPSs for a firm at any one time to $1,000,000. The size and amount limitations would generally be applied by treating members of a controlled group as one taxpayer.

g. The pending bills would also require that a company that utilizes the SBPS not have outstanding any securities that are subject to SEC regulation. This reflects the intent of the drafters that the legislation benefit companies that have not sought access to the equity markets.

Estimates vary as to the cost to the Treasury of adoption of the SBPS. Small Business United estimates that there would not be any actual cost to the Treasury 10/ while cost estimates for at least one proposal amounted to several hundred million dollars. There are a number of variables, particularly the size of the business covered and the size of an investment tax credit feature, that could have an important impact on the cost. It is also anticipated that the proposal would generate capital investment, new jobs and additional federal revenues. Unlike many federal programs, there would not be any risk of loss to a government agency.

9/ The two House bills propose that companies with equity capital of less than $10 million be eligible, whereas the Senate bill proposes a $25 million limit. The Homestead conference defined a small business as one with net worth of less than $6,000,000 or two year average net profits of less than $2,000,000.

10/ Small Business United Washington Presentation, May 4 & 5, 1982, at 8.

It is anticipated that there could be a substantial amount of institutional involvement in the sale of SBPSs. Certain banks and insurance companies have expressed interest in the SBPS concept. It is also expected that broker-dealers could sell participation interests in one SBPS or in several SBPS investments whereby investor risk would be reduced through diversification. Pooling of several SBPS investments would also make them more appealing to institutional investors. Care would have to be taken in structuring the pools, however, to avoid certain regulatory problems, such as infringement of the Investment Company Act of 1940.

Recommendation 2 - A "Capital Bank" should be created to provide a stable, continuing source of leverage for the SBIC industry.

A small business investment company ("SBIC") is a privately-organized, privately-capitalized and privately-managed source of venture capital for new and growing independent businesses. Although SBICs are operated by the private sector, they are licensed under the Small Business Investment Act of 1958 ("SBIA") and regulated by the SBA. The SBIC program was founded on the premise that a cooperative effort between government and the private sector could help to meet the public policy goal of providing equity capital to small business. In return for complying with SBA regulations and investing solely in small companies, SBICs are entitled to borrow money from the Federal Financing Bank at market rates plus a servicing fee. During the past 23 years, SBICs have provided over $4 billion in venture capital to 46,000 small businesses. 11/ On

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11/ Source: National Association of Small Business Investment Companies.

April 1, 1982, there were 361 active SBICs with assets of nearly $1.6 billion almost equally divided between private capital and government loans. 12/

In order to satisfy the future funding needs of SBICs, a privately-managed, quasi-public "Capital Bank" should be established to provide a continuing source of leverage funds for the SBIC industry. The bank, which would be federally chartered, would be similar to existing entities, such as the Federal National Mortgage Association and the National Consumer Cooperative Bank. On the basis of historical default and loss rates of SBIC debentures, it is estimated that the bank could eventually support aggregate SBIC industry borrowings in the range of $2-3 billion.

The SBIC capital bank could have the following principal features:

a. It would be privately managed and would utilize the resources and techniques of the private sector once it is established and operational.

b. It would be initially capitalized by the U.S. Treasury at the level of $100 million. This would represent a one-time, non-recurring investment by the federal government.

c. The Treasury investment would be retired over time out of profits earned by the bank. The bank's income would be derived from spreads on its loans, investment income and service fees.

d. SBICs would be obligated to purchase "participating" stock in the bank.

e. The bank would be authorized to issue its own securities (notes, debentures, stock) in conventional financial markets. These would be tax-exempt, backed by the SBIC debentures which the bank had purchased and would be insured against loss by the bank. The bank would also be authorized to pool the SBIC debentures it purchased and sell participating interests in those pools. The pools would be structured so as to fall outside of the definition of an "investment company" under the Investment Company Act of 1940. The participating interests would have similar tax-exempt status and insured or guaranteed characteristics.

12/ U.S. Small Business Administration, SBIC Digest, Part 1 (April 1982) at 8.

f. On a phased basis, the bank would become an institution owned by persons in the private sector.

Recent budget cuts have limited the authorized funding for the SBIC program for fiscal 1982 13/ and 1983 14/ to a maximum of $160 million per year. These restrictions in the availability of leverage occur at a time when the need and demand for leverage have increased. Rapid growth of the industry over the past several years, an increased rate of demand for venture capital and the roll-over of maturing SBIC loans, which must be taken out of annual appropriations, have escalated the SBIC industry's need for leverage. Accordingly, there is a need to establish a stable source of continued funding support, such as a Capital Bank, for the SBIC program.

Recommendation 3 - The $35 million ceiling on leverage to an SBIC should be removed. 15/

Since 1976, the SBIA has restricted to $35 million the amount that an SBIC can borrow. The ceiling had been raised to $15 million in 1972 from its original level of $7.5 million. Although it is necessary to allocate the limited federal contribution for the SBIC program among many SBICs, this ceiling appears to arbitrarily limit the size of SBICs. Since SBICs can be leveraged at a 4 to 1 ratio, there may not be an incentive to form a new SBIC with more than $8.7 million in private capital. The ceiling also is a deterrent to growth through capitalizing earnings and to current SBIC owners' increasing their SBIC investments. SBICs are

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13/ National Association of Small Business Investment Companies, "NASBIC News", July 30, 1981, at 1.

14/ Pub. L. 97-276 (1982).

15/ This suggested revision in the SBIA is set forth in H.R. 5302, introduced on December 16, 1981, by Representatives Nowak and Marriott. Hearings on the bill were held on March 24, 1982. Further legislative action on the bill is not anticipated during the 97th Congress.

restricted to investing up to 20 percent of their private capital in any one small firm. This limitation also restricts the maximum investment that an SBIC can make in a small business.

Recommendation 4 - Subchapter M of the Internal Revenue Code should be amended to provide conduit tax treatment for shareholders of business development companies.

The Small Business Investment Incentive Act of 1980 amended the Investment Company Act of 1940 to establish a new system of regulation for certain closed-end investment companies that provide capital and make available significant managerial assistance to small businesses. Those companies can elect to be treated as business development companies ("BDCs"). Election as a BDC facilitates making a public offering while enabling the BDC to take advantage of a special system of regulation. In general, BDCs are permitted greater flexibility than other investment companies in dealing with their portfolio companies, issuing securities and compensating management.

The 1980 Act did not conform subchapter M of the Internal Revenue Code to allow conduit or flow through tax treatment to the shareholders of a BDC under the same rules as are applied to a regulated investment company ("RIC"). An RIC is a corporation that qualifies as such under the Investment Company Act of 1940. Under subchapter M, the RIC is not subject to the corporate income tax. As a result, the RIC shareholders, but not BDC shareholders, receive conduit tax treatment.

This poses a dilemma for a company that already is eligible for conduit treatment. It can either remain an RIC, which is subject to the system of regulation applicable to most investment companies but receives conduit tax treatment, or it can elect to become a BDC, which is subject to an alternate system of regulation but is not eligible for conduit treatment.

Conduit treatment, particularly the elimination of the double tax on capital gains (i.e., elimination of a corporate capital gains tax incurred when a BDC sells stock of its investee companies, leaving a shareholder-level tax incurred when these gains are distributed or the BDC stock is sold), is of considerable importance to companies that specialize in venture capital investments. The absence of the cross reference may be restricting Congress' effort to promote investment in small business inasmuch as only a small number of BDCs have been established since 1980.

B. RELAXING ERISA AND SIMILAR REGULATORY RESTRICTIONS TO ENCOURAGE INVESTMENT IN SMALL BUSINESS

1. Statement of the Issue

The adoption of the Employee Retirement Income Security Act of 1974 ("ERISA") has had a significant impact upon the investment of private pension assets in small business. Employee plan asset managers, who were uncertain about their responsibilities under ERISA's new prudent person investment standard, adopted conservative investment strategies. Small business access to pension funds was reduced as plans invested more heavily in blue chip securities. The loss of potential pension investments also occurred at a time when the number of public offerings had diminished. This combination of factors had a particularly adverse impact upon small business access to capital during the late 1970's. Although there have been a number of developments in recent years that have helped to increase pension fund interest in small business investments, investments by pension funds in small business have not kept pace with the growth of pension assets in general.

2. Background

In January 1977, a Small Business Administration task force expressed its concern that ERISA's fiduciary standards had isolated $200 billion in pension assets from all but blue chip and fixed income securities. 16/ The task force suggested an amendment to the ERISA prudent person rule to clarify its application to the total portfolio of pension fund investments rather than to individual investments. The task force also recommended

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16/ Report of the SBA Task Force on Venture and Equity Capital for Small Business (1977).

that a "basket" of 5 percent of fund assets be designated as permissible for investment in companies having less than $25 million in net worth and in larger companies having limited marketability for their securities. 17/

Legislation to revise and clarify the prudent person rule was introduced in Congress in 1977 and 1978 by Senator Bentsen and Representative LaFalce. 18/ Subsequently, the NASD, in its 1979 study of small business financing, also advocated application of the prudence standard to the total portfolio and adoption of a basket clause for small business investments. 19/

Shortly after the NASD report was issued, the Department of Labor published, effective July 23, 1979, a final rule interpreting the investment duties of a fiduciary under the prudent person rule. 20/ The regulation adopted the total portfolio approach to evaluating investments and the accompanying discussion of the regulation indicated that investments in small business would be permitted under certain circumstances:

> . . . [T]he prudence of an investment decision should not be judged without regard to the role that the proposed investment or investment course of action plays within the overall plan portfolio. Thus, although securities issued by a small or new company may be a riskier investment than securities issued by a "blue chip" company, the investment in the former company may be entirely proper under the Act's "prudence" rule. 21/

17/ Id. at 14.

18/ S. 285, 95th Cong., 1st Sess. (1977) ; H.R. 9549, 95 Cong., 1st Sess. (1977); and H.R. 12666, 95th Cong., 2d Sess. (1978).

19/ NASD, Small Business Financing, The Current Environment and Suggestions for Improvement (1979), at 19.

20/ 29 C.F.R. §2550.404a-1 (1979).

21/ 44 Fed. Reg. 37222 (1979).

Although issuance of the prudence regulation represented an important development in reopening small business access to pension funds, a number of difficulties have remained. The Department of Labor has not defined the parameters of prudence with respect to investment in small business. The Department is also in the process of drafting a definition of the term "plan assets" to repropose for comment. The design of that regulation could have a serious impact on the degree to which pension funds may be a viable funding source for venture pools that invest in small business. There are also a number of state limitations on public pension fund investments that inhibit the ability of those entities to direct their sizable assets toward small business. In addition, there are a number of structural barriers to investments by pension funds and other institutions in small business. Certain types of intermediaries may be able to help reduce the negative impact of such barriers on institutional managers.

3. Recommendations

Recommendation 1 - The Department of Labor, in conjunction with other appropriate government agencies, should disseminate to the fullest extent possible its position that investments by employee plans in smaller companies are not per se imprudent.

In its 1979 prudence regulation, the Department of Labor indicated that investments by employee plans in small business are neither per se prudent nor per se imprudent and that a small business investment may be viewed in the context of the investment strategy for the entire plan portfolio. The Department has not offered any criteria, however, to assist plan managers in determining the degree to which investment in small business may be prudent. In addition, the Department's policy has been to avoid passing judgment on the prudence of a particular investment for a plan. This lack of guidance may have had a dampening

effect on the degree to which plans invest in small business since plan managers do not have a clear basis for determining the portion of a plan's assets that may be prudently invested in small business.

There are also other factors that have had the effect of diminishing employee plan investments in small business. Although ERISA was passed in 1974, it was not until April 1978, that the Department of Labor disclosed its flexible approach to plan investment strategy when it proposed the prudence regulation for public comment. 22/ Over three and one-half years had elapsed during which most plan administrators believed that an investment in any small business would be violative of the ERISA prudent person rule.

In addition, the Department of Labor issued for public comment, as discussed more fully in the next recommendation, a proposed definition of the term "plan assets" under ERISA that caused the cessation of the flow of pension funds to venture capital firms for almost one year. This occurred immediately following the issuance of the prudence regulation.

During these time periods, it is likely that, given a different regulatory environment, millions of dollars would have flowed into prudent small business investments. Reportedly, there are a number of plan administrators who still do not believe that investment in at least certain small businesses, such as venture capital firms, would be appropriate under any circumstances. Although the Department of Labor has taken some steps to clarify its position, its message has yet to reach everyone. As a consequence of the confused signals emanating from the

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22/ 43 Fed. Reg. 17480 (April 25, 1978).

Department of Labor, the ERISA prudent person rule has not been permitted to operate as effectively as it could. A further effort by the Department to disseminate to the fullest extent possible its position that it may be prudent (i.e., not per se imprudent) for employee plans to invest additional assets in small business would be appropriate.

> Recommendation 2 - The Department of Labor should adopt a definition of the term "plan assets" under ERISA to permit venture capital managers to continue to invest pension plan funds without qualifying as plan fiduciaries and without venture pool assets qualifying as plan assets.

Venture capital pools are established to invest funds in small, high-potential business enterprises. These pools have grown substantially over the past several years. As the size of venture capital pools has grown, the level of pension funds flowing into venture capital pools has also increased. It has been estimated that pension fund commitments to venture capital have risen from approximately $1 million in 1977 to $228 million during the first six months of 1982. 23/ While only 5.3 percent of the pension funds with less than $100 million are currently invested in venture capital, over 40 percent of funds greater than $500 million have invested in venture capital. 24/

In August 1979, approximately one month following the effective date of the revised prudence regulation, the Department of Labor proposed a definition of the term "plan assets" under ERISA. 25/ Under the Department's proposal, there would have been a "look-through" of the interest held in a venture capital pool by an employee plan so that pool assets would have been deemed to be plan assets under ERISA. This would have created a

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23/ 22 Venture Capital Journal 6 (July 1982)

24/ 15 Institutional Investor 105 (Sept. 1981)

25/ 44 Fed. Reg. 50363 (1979).

number of problems for venture capital pools under ERISA. 26/ The managers of a venture firm would have been fiduciaries under ERISA to whom control of plan assets had been delegated. A plan investing in the pool would have violated ERISA's requirement that plan assets, with certain exceptions, be held in a trust by or under the control of a trustee. The plan trustee would have remained liable for acts of the venture manager over which the trustee did not have any control. There would also have been a substantial liklihood that the prohibited transaction provisions of ERISA would have been violated by venture firms that often own interests in their portfolios and serve as officers and directors for portfolio companies.

In reply to the views expressed concerning the proposed plan asset regulation, the Department of Labor, on June 6, 1980, proposed for comment a revised definition of the term "plan assets." 27/ The proposed revision provides that if certain conditions are met, an investment in a venture capital pool by a plan would not be considered to be a delegation of

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26/ As a result of the issuance of the proposed plan asset regulation, pension plan investments in venture capital pools declined sharply during the last quarter of 1979 and first half of 1980. Boeing, GTE, Hughes Aircraft, Allied Chemical, B.F. Goodrich and General Electric were among the firms whose plans were reported to have reconsidered their intentions to invest in venture capital investments. Zock, "Small Business Access to Capital Markets Through Pension Funds" (Studies of Small Business Finance for the Inter-Agency Task Force on Small Business Finance, 1982).

27/ 45 Fed. Reg. 38084 (1980).

investment management authority and the venture pool assets would not be considered to be plan assets. 28/

The Department of Labor has not yet adopted the revised plan assets definition as it applies to venture capital firms. The Department is urged to adopt a definition of the term "plan assets" that would permit venture capital managers to invest pension funds without qualifying as plan fiduciaries and without venture pool assets qualifying as plan assets.

> Recommendation 3 - States should be encouraged to revise their public pension laws to permit investment of public pension plan assets in accordance with a flexible prudent person standard applied to the portfolio as a whole.

At the present time, most states have restrictive lists that govern the manner in which public plan assets may be invested. Such lists generally do not permit investments in small business. A number of states have a combination of a legal list with provisions permitting certain assets to be invested in accordance with the prudent person standard. Ten states, including Delaware, Idaho, Illinois, Kentucky, Maine, Nebraska, New Jersey, Oregon, South Dakota and Washington, have adopted a prudent person standard

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28/ Following the Department of Labor action, the amount of plan assets flowing to venture capital firms has increased substantially. It is estimated that approximately $197 million in pension assets flowed into venture capital pools in the second half of 1980. According to recent estimates, $710 million of the approximately $750 billion in pension funds or less than .1 percent of fund assets are currently invested in venture capital deals. 22 Venture Capital Journal 6 (July 1982).

that is generally not subject to state statutory restrictions governing the investment of public pension funds. 29/

One significant reason for changing to the prudent person standard relates to an expectation that better rates of return can be attained. Another important factor has been the interest that states have in furthering economic and community development goals through their pension systems. The prudent person rule generally would provide plan managers with a greater choice in selecting investment alternatives than would a legal list. Plan investment policies governed by legal lists also would appear to be less adaptable than those governed by the prudent person rule to changes in market conditions, institutional investment practices and the needs of the retirement system.

Private pension assets are managed under the ERISA prudent person standard. The Department of Labor's clarification of the prudent person standard to permit evaluation of investments in terms of overall portfolio strategy has helped to make the ERISA standard a more useful guide for public plans. However, as indicated above, the regulatory history of the ERISA prudent person rule has discouraged investments in small business. If the ERISA standard had been broadly interpreted from its inception, it should have provided flexibility to account for plan

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29/ National Conference of State Legislatures, "Investment Policy for Public Employee Pension Funds: An Overview of Recent Changes" (Legislative Finance Paper No. 28, 1982).

characteristics, risk, liquidity, diversification and other factors. Public plans may now be in a position to begin to benefit from the fundamental flexibility of the ERISA standard.

> Recommendation 4 - Pension funds and other institutions should be encouraged to utilize intermediaries experienced in small business financing in order to facilitate investment in small business.

Although there is a growing recognition that institutional investments in small business are desirable, pension fund and other asset managers often do not have either the expertise or time necessary to research and select promising small business investments. In particular, institutional managers would have to devote considerable resources to the investigation of small business investments. However, the cost of obtaining and analyzing information on potential small business investments is only one factor that deters institutional investment in small business. Small business investments often are not liquid or may have a volatile market that results in uncertainty about resale value. Moreover, many small business investments can only absorb a limited amount of funds.

In response to the problems that accompany small business investments, a number of approaches have been developed in both the private and public sectors to take advantage of the benefits that small business investments can offer to pension funds and other institutions. These approaches serve to minimize the risks and costs previously associated with investments in small business. In general, these approaches involve the utilization of at least one intermediary between the institution and the small business. Intermediaries currently available for use by pension

funds include venture capital firms, Small Business Investment Companies, small company investment funds, broker-dealers, and state investment programs such as those in Kansas and California. 30/ Both private and public pension funds are encouraged to further explore the potential investment assistance that these and other intermediaries can provide in developing small business investment opportunities.

30/ In the early 1970's, the independent board that oversees the administration of the Kansas Public Employees Retirement System, a $1.1 billion system that includes all public employees in Kansas, determined that a larger percentage of fund assets should be invested in Kansas small business. In 1971, an SBA fund was created to purchase up to $15 million of the guaranteed portion of SBA loans already made by bank intermediaries. Approximately $5 million of such loans are currently in the fund. In 1973, the system created an equity fund and hired a Kansas investment firm to act as an intermediary in locating promising business opportunities in the State. Since that time, the fund has obtained equity positions with a number of small firms in Kansas. Efforts are being made to minimize the risk to the plan by investing in companies that have substantial track records. The fund, which contains $73 million, has also invested in major corporations with branches located in Kansas.

California has established a Pension Investment Unit ("PIU"), separate from its public funds, that attempts to identify capital gaps in the economy. PIU then endeavors to fill those gaps within the constraints of pension capital (i.e., liquidity, return and security of assets) by convincing the state's public funds to invest. PIU has arranged a forward commitment to purchase $280 million in SBA loans and is working on a plan to insure pools of commercial loans. PIU also serves an educational function by bringing venture capital firms, brokers and private pension funds with venture capital experience together with the public funds in order to assist the public funds in venture capital investing.

C. REDUCING COSTS ASSOCIATED WITH SECURITIES REGULATION

1. Statement of the Issue

The financing of small business, in both public and private offerings of securities, requires incurring significant costs to comply with state and federal regulatory requirements. The legal fees involved in such offerings are incurred in connection with preparing disclosure and registration materials and selling agreements, and clearing the regulatory hurdles at the state and federal level, while accounting expenses are attributable primarily to auditing and reviewing financial statements. The cost of these professional fees may deter smaller businesses from conducting private or public offerings of securities and, consequently, limit their access to potential investors and capital.

Additional legal and accounting expenses are incurred following a public offering or whenever the company reaches a specified size, as the company must comply with the periodic reporting requirements of the Securities Exchange Act of 1934 ("Exchange Act"). 31/ The reporting

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31/ 15 U.S.C. §§ 78(a) et seq. Under §15(d) of the Exchange Act, a company which has had a registration statement declared effective pursuant to the Securities Act of 1933, 15 U.S.C. §§ 77(a) et seq., as amended (the "Securities Act"), must file annual and quarterly reports, and statements of material changes. Section 12(g) of the Exchange Act and Rule 12g-1 thereunder, as recently amended, [Exchange Act Release No. 18647, 47 Fed. Reg. 17,046 (1982) (to be codified at 17 C.F.R. § 240.12g-1)], require a corporation to comply with the reporting requirements under the Exchange Act whenever it has 500 shareholders and total assets of $3 million at the end of a fiscal year. Generally, the duty to file periodic reports will be suspended whenever a company has fewer than 300 shareholders and less than $3 million total assets for each of the three preceding fiscal years, provided that no registration statement became effective during that three-year period. [Rules 12g-4, 15d-6, Exchange Act Release No. 18647, 47 Fed. Reg. 17,046 (1982) (to be codified at 17 C.F.R. §§ 240.12g-4, 240.15d-6.]

requirements apply equally to all companies subject to the requirements and make no distinctions between the largest firms and the smallest firms. Generally, smaller companies do not have the financial or personnel resources to comply with these reporting requirements. Further, considering the different sizes of businesses reporting under the system, certain of the disclosure requirements, while perhaps relevant to large businesses, do not necessarily yield information important to investors in the context of small businesses. Finally, the cost of disclosing certain information may exceed the benefits to shareholders or potential investors. 32/

2. Background

The sale of securities through a public or private offering normally requires development of a disclosure document providing detailed information concerning the company, its business, executives, assets and other material information, including financial statements. 33/ Typically, lawyers for the issuer will assist the issuer in preparing the disclosure document, while the issuer's independent certified public accountants will audit and certify the financial statements. Although the SEC and the Financial

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32/ See Summary of Comments, SEC Small Business Hearings and Proposed Form S-18, 83-90, Securities Act Release Nos. 5914, 43 Fed. Reg. 10,876 (March 6, 1978) and 5915, 43 Fed. Reg. 10,888 (March 6, 1978).

33/ This document is called a prospectus in a public offering and an offering circular or memorandum in a private offering. In a private placement sold exclusively to certain "accredited investors," typically institutional investors or sophisticated, wealthy individuals, Regulation D, the SEC rules that govern non-public offerings, does not mandate that specific disclosure be furnished.

Accounting Standards Board ("FASB") 34/ have provided certain guidelines and standards that the disclosure document and financial statements must meet, the issuer, with assistance from its professional advisors, must exercise its best judgment in preparing the documents and determining precisely what information shall be included.

As a means to reduce the costs of registration for smaller companies that are not publicly-held and are registering securities for the first time, the SEC has promulgated Form S-18, which is a shortened version of the primary registration form, Form S-1. In Form S-18, the SEC eliminated certain disclosure requirements contained in the Form S-1 and required registrants to provide only two years of financial statements prepared in accordance with generally accepted accounting principles ("GAAP") rather than three years of financial statements prepared in accordance with Regulation S-X, 35/ as is required under Form S-1. Issuers are limited, however, to raising $5 million under Form S-18.

With respect to nonpublic offerings of securities, i.e., private placements, the SEC recently adopted Regulation D, a series of six rules that provide a safe harbor for offerings exempt from registration, but

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34/ The FASB was created as an independent board under the auspices of the Financial Accounting Foundation, an organization funded by the accounting profession. The FASB has the responsibility for settting uniform standards for financial statements.

35/ 17 C.F.R. §§ 210.1-01 through 210.12-29 (1981). Regulation S-X prescribes the form and content requirements for financial statements required to be filed with the SEC under the federal securities laws.

impose certain requirements and standards on such offerings. 36/ Under Rule 504, for small offerings up to $500,000, the SEC has eliminated any federal requirements for a specifically mandated disclosure document or financial statements. 37/ For offerings above $500,000, Rules 505 and 506 impose varied disclosure requirements related to the size of the offering and the informational requirements of the Securities Act registration forms. An issuer, not subject to the reporting requirements of the Exchange Act, that conducts an offering of up to $5 million must provide all purchasers with the same kind of narrative information as is required to be disclosed in Part I of Form S-18. If the offering exceeds $5 million, the narrative disclosure to be provided must conform to the information requirements of Part I of a registration form that the issuer would be entitled to use. However, the rules provide that the information need not be disclosed if, in the opinion of the issuer and its counsel, it is not "material". In addition, no specified information is required to be provided if all purchasers are "accredited investors," i.e., certain institutions and wealthy individuals.

With respect to financial statements, for offerings up to $5 million, Regulation D requires that only the most recent year of the two years of financial statements provided be certified. For offerings in excess of $5 million, the Regulation requires the same type of financial statements called for by the registration form which the issuer would be entitled

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36/ Securities Act Release No. 6389, 47 Fed. Reg. 11,251 (1982) (to be codified at 17 C.F.R. §§ 230.501 - .506). Rules 501 through 503 state general requirements for using Regulation D. Rules 504 through 506 detail specific types of offerings.

37/ Essentially, the SEC has deferred to the states in regulating such offerings.

to use. If any issuer, other than a limited partnership, cannot obtain audited financial statements without unreasonable effort or expense, only the issuer's balance sheet, dated within 120 days of the start of the offering, must be audited. If a limited partnership cannot obtain the required audited financial statements without unreasonable effort or expense, it may furnish financial statements that have been prepared on the basis of federal income tax requirements and examined and reported on in accordance with generally accepted auditing standards by an independent public or certified accountant.

Realistically, the costs of issuing securities may be difficult to reduce further. Even if the SEC were to reduce further the required disclosures, conservative securities counsel may continue to advise the the preparation of an extensive disclosure document in order to protect the issuer from civil liability under the antifraud provisions of the securities laws. For example, Form S-18 sought to reduce the time necessary for the preparation of the required documents by shortening the required items to be discussed in the prospectus and by requiring only two years of GAAP financials, rather than three years of Regulation S-X financials. Nevertheless, an SEC study indicates that Form S-18 may not have reduced costs significantly for most issuers. 38/

38/ Statistics compiled by the Directorate of Economic Policy and Analysis ("DEPA") of the SEC do not indicate that Form S-18 has significantly reduced the costs of an offering. However, the almost total substitution of Form S-18 for Form S-1 "as a means to register smaller IPO's [Initial Public Offerings] suggests that there are perceived benefits from its use." DEPA, "Form S-18: A Monitoring Report on the First 18 Months of its Use," SEC (1981).

Additional costs are incurred in other areas of securities regulation. The Exchange Act requires certain companies, generally those that have conducted a public offering and those with more than 500 shareholders and $3 million total assets, 39/ to file reports with the SEC. The company is required to file an annual report, on a Form 10-K, providing detailed financial statements. In addition, the company must file quarterly reports on Form 10-Q, with interim financial statements, and other occasional reports on Form 8-K, as material events occur.

Although the SEC has developed Form S-18 to ease the burden for smaller companies conducting registered public offerings, the SEC has taken no action to provide similar relief for smaller reporting companies under the Exchange Act. However, the SEC, has moved to adjust the standards that prescribe which companies are subject to the reporting information as to the company and its business, as well as audited requirements. Nevertheless, although fewer small businesses must comply with the reporting requirements as a result of those adjustments, significant numbers of small businesses remain reporting companies and must conform to the same standards of disclosure as the largest multi-national corporations.

3. Recommendations

Recommendation 1 - A. The SEC should exercise its jurisdiction under §3(b) of the Securities Act to determine that no federal interest exists in offerings of less than $5 million by "small business concerns" not required to be registered under §12 of the Securities Exchange Act at the time of the offering. "Small business concerns" should be defined to exclude (i) divisions or subsidiaries of non-exempt companies and (ii) tax shelter type offerings.

39/ See note 31, supra.

B. Section 12(g) of the Exchange Act should be amended, either by law or regulation, to increase materially the threshold criteria for registration, using net worth (shareholder's equity) as the test.

This recommendation would provide a complete exemption from Section 5 of the Securities Act, leaving enforcement to Section 12(2) of that Act and Rule 10b-5 under the Securities Exchange Act. A minimum per share offering price (e.g., $2/share) might be incorporated to reduce the possible abuses of penny stocks. The recommendation envisages that each exempt issuer would send to its shareholders annual audited financial statements and quarterly unaudited statements, with such additional information as the company may elect.

In effect, the recommendation relieves small businesses from the time and cost burdens now imposed by initial public offerings and the continuous reporting requirements of the securities laws. The Forum suggested $5 million net worth and 2,000 shareholders as the threshold for §12(g) reporting requirements.

NOTE: Recommendations two through six represented the proposals approved by the drafting group. Recommendation one was offered as a minority position and approved by the participants. Recommendations two through six were also approved to the extent they are not inconsistent with Recommendation one or should the SEC not act on Recommendation one.

Recommendation 2 - The SEC should adjust the periodic reporting requirements for small businesses, with a view toward simplification where appropriate, and, in particular, is urged to adopt a rule which permits a registrant to satisfy the Exchange Act reporting and proxy requirements if the registrant makes available to its security holders and files with the SEC:

(i) within 90 days after the end of its fiscal year, financial statements audited on the basis of GAAP for the last two fiscal years, and,

(ii) 45 days after the end of each of its first three fiscal quarters, an unaudited quarterly financial statement in the same form as required for the 10-Q report.

In recent years, GAAP and disclosure standards have become increasingly technical, thus the cost of providing financial information has increased. Because the requirements apply equally to large and small businesses, compliance is disproportionately costly to small business and does not necessarily yield information important to investors. Moreover, a significant number of registrants subject to the Exchange Act reporting and proxy requirements are not listed on an exchange or NASDAQ, therefore, the limited investor interest is insufficient to justify the cost of preparing extensive 10-K reports and proxy statements.

The recommendation is directed toward those companies whose securities are not actively traded and, therefore, need less information publicly available. 40/ Registration on Forms S-2 and S-3 would be unavailable for any company choosing to satisfy the reporting requirements under this recommendation.

40/ A study by A.E. Osborne and Associates, commissioned by the Small Business Administration, indicates a correlation between number of shareholders, and asset, revenue and employee size of companies. Consequently, by adjusting the reporting system to provide relief to small businesses, a relatively small percentage of shareholders, compared to the percentage of firms whose obligations are reduced, may be adversely affected by reducing the information available.

Recommendation 3 - The SEC should consider amending Form S-18 to permit its use for offerings of securities up to $10 million.

Some relatively small companies which qualify for the use of Form S-18 wish to raise between five and ten million dollars. If the ceiling on S-18 were raised, those companies could benefit from regional filing and less stringent financial statement requirements. The recommendation recognizes that SEC recently expanded the availability of Form S-18 and that the volume of filings resulting from those changes and the adoption of the recommendation might lengthen processing periods in the Commission's Regional Offices.

Recommendation 4 - The FASB, and other interested parties, should identify the critical aspects of financial information which lenders to and investors in small business need for investment and credit decisions. Those parties should insure that requirements for financial statements and disclosures are responsive to these needs, but subject to the cost-benefit trade-offs of providing information.

Financial accounting standards and disclosures have become extremely complex and expensive for small business to comply with. Certain information must be made available in order to maintain the flow of capital into small business. However, some information which is currently disclosed is useless to investors and needlessly costly to small businesses. 41/

41/ The drafting group specifically rejected a dual set of accounting principles, i.e., "Big GAAP-Little GAAP" as a means of reducing accounting costs.

Recommendation 5 - The SEC should introduce the concept of "substantial good faith compliance in all material respects" into the exemptive scheme by amendment of existing rules and/or adoption of a new rule or rules to provide that substantial good faith compliance in all material respect will satisfy the requirements of such exemptions and that no Section 12(1) liability will attach where noncompliance is both innocent and immaterial.

Inadvertent failure to comply with every requirement of an exemption can result in civil liability and the loss of the exemption for the entire transaction. Under the current liability scheme, a disgruntled investor need show only technical noncompliance with the terms of an exemption, not that he was misled in any way, in order to rescind his investment. This recommendation would prevent liability only in situations in which technical noncompliance is not material, however, it would not provide an exemption from the anti-fraud provisions. Moreover, it would insure the exemption if substantial good faith compliance in all material respects exists.

Recommendation 6 - The SEC should amend Rule 144 to allow the sale of securities thereunder by nonaffiliates after a three-year period without further regulatory requirements.

Securities acquired in a nonpublic offering are referred to as "restricted securities" because they are not freely transferable. 42/ A holder of restricted securities may resell his securities only after registration under the Securities Act, or pursuant to an exemption therefrom. 43/ Generally, Section 4(1) exempts resales of restricted securities, however, that Section gives no guidance as to when the resale may be effected, to whom, or in what manner. Investors relying on Section

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42/ See Rule 144 (a)(3), Securities Act Release No. 6389, 47 Fed. Reg. 11,251 (1982) (to be codified at 17 C.F.R. § 230.144(a)(3)).

43/ See, e.g., Regulation D, Rule 502(d), Securities Act Release No. 6389, 47 Fed. Reg. 11,251 (1982) (to be codified at 17 C.F.R. § 230.502(d)).

4(1), therefore, run a substantial risk that they may be classified as underwriters, which are specifically excluded from the exemption. 44/

In order to clarify the Section 4(1) exemption, the SEC instituted Rule 144 as a safe harbor for resales of securities acquired after April 15, 1972. 45/ Although Rule 144 codified the position of the SEC staff with respect to certain resales under Section 4(1), the requirement that public information about the issuer of the securities be available prior to resale of such securities 46/ left many small businesses without the assurance of the safe harbor provisions. Most small businesses do not have the required information publicly available and would be overburdened by the reporting requirements.

The recommendation simply amends Rule 144 to allow free transferability of restricted securities after a three-year holding period. The three year holding period should be sufficient to establish the investment intent of the purchaser, yet the unrestricted status after that time should enhance the marketability of the securities. In addition, the recommendation will remove the questions about whether an exemption applies, thereby lowering the cost of complying with the exemption.

44/ Securities Act § 4(1), 15 U.S.C. § 77d(1) (1976). Generally, any person who purchases securities from an issuer with a view toward distribution is an underwriter. The determination of underwriter status, however, requires a subjective analysis. See Securities Act § 2(11), 15 U.S.C. § 77b(11) (1976); and Rule 144, 17 C.F.R. § 230.144 Preliminary Note 2 (1981).

45/ 17 C.F.R. § 230.144 (1981).

46/ Rule 144(c), 17 C.F.R. §230.144(c) (1981).

D. UNIFORM FEDERAL-STATE SECURITIES REGULATION

1. Statement of the Issue

Since the adoption of the Securities Act, both the federal government and the individual states have regulated the issuance of securities. With 51 jurisdictions, each regulating offerings of securities, inevitably, the restrictions and standards vary significantly from jurisdiction to jurisdiction. Any company that sells securities, in a public or private offering, 47/ must comply with the specific requirements of the Securities and Exchange Commission and each state in which the securities are to be offered.

While both large and small businesses incur substantial expenses to comply with this regulatory pattern, the burden on smaller businesses is proportionately heavier since these costs often are a significant percentage of the total amount of capital raised through the offering. With their

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47/ For purposes of this report, a public offering of securities is an offering registerd with the SEC pursuant to the Securities Act. The registration statement is filed with and reviewed by the SEC. Certain registration forms, such as S-18 and S-1, are commonly used by small businesses.

A private offering, as used in this report, is an offering that is exempt from the registration requirements of the Securities Act. Although the SEC does not review any materials for a private offering, SEC "safe-harbor" rules require that information be provided to investors, normally the "same kind" of information that would be required to be given on Form S-18. Numerous exemptions exist but the most commonly discussed ones in this report will be those provided in §§ 4(2) and 3(b), of the Securities Act, for nonpublic and SEC approved offerings respectively.

more limited resources, smaller businesses are less able to afford the expense of complying with the intricacies of various state securities laws for public or private offerings. Consequently, the markets for their stock are confined to a more narrow geographic area, thereby depriving these businesses from access to larger numbers of potential investors. In order to facilitate access to capital by smaller companies, securities regulations among the individual states, and between the states and the SEC, should be made more uniform.

2. Background

If a company plans a public offering of common stock, it must file a registration statement with the SEC and also register the securities in each of the states in which it plans to offer securities. Consequently, the company will have to coordinate its offering with 51 different jurisdictions if it seeks a nationwide distribution. 48/ As a practical matter, except with respect to partnership offerings, many state securities administrators often defer to the SEC if the SEC actually reviews the registration statement, 49/ although the state administrators sometimes request changes.

If a company plans a private offering, which is exempt from the SEC registration requirements, it must still coordinate with the states

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48/ Most small businesses do not, of course, attempt such a widespread offering. Offerings by small business are often directed at investors in one state or at investors in a region of the country, normally involving 6 to 10 states.

49/ The SEC announced in 1980 that henceforth it would not review all Securities Act registration statements or proxy statements filed by issuers. Consequently, with this "selective review process", state securities administrators are more likely to review the disclosure materials of registration statements.

in which the offering occurs. While in a public offering many states defer to the SEC, the states are more involved in nonpublic offerings since there is no SEC review. Further, while many states accept the SEC filing in a public offering, the states' exemptions for private offerings are quite different from and more limited than the SEC exemptions and vary significantly among the states. Other than the SEC's newly adopted Regulation D, no efforts have been made for developing a uniform private offering exemption. 50/

Previous attempts at coordinating securities regulation between the states have been made, but with limited success. Approximately thirty states have adopted in some form a "Uniform Securities Act" 51/ while other states have enacted portions thereof. The statute, which provides, among other things, for the registration of securities and certain exemptions therefrom, may have provided some needed uniformity by virtue of its common terms and conditions. However, despite the intent of the statute "to make uniform the law of those states which enact it and to coordinate the interpretation and administration of this act with the related federal regulation," 52/ statutory language and interpretations of the provisions vary from state to state.

50/ The Uniform Securities Act does provide for a small private offering exemption that permits "offers" to ten persons in the state.

51/ 7 U.L.A. 691 (1956). This uniform act was drafted by Professor Louis Loss for the National Conference of Commissioners on Uniform State Laws and the American Bar Association. See Loss, L., Comments on the Uniform Securities Act (1976).

52/ Uniform Securities Act, § 415. In addition, § 303 provides for "registration by coordination" if the securities have been registered with the SEC.

In addition to the review of the information disclosed in the registration statement, many states, unlike the SEC, conduct a "merit evaluation," whereby the proposed offering must conform to certain quality requirements, commonly kown as "fair, just and equitable" standards. These standards attempt to protect investors by restricting the conduct of the issuer. For example, certain states impose standards for maximum dilution, limitations on the amount of "cheap" stock and maximum underwriting compensation. The interpretation and application of fair, just and equitable standards varies significantly from state to state. Often, counsel for the issuer must negotiate with several state administrators to obtain the right to offer securities within the state. Thus, the costs of conforming to a multitude of state requirements can be significant for a small business and may thereby deprive small business of access to potential investors.

Congress has acknowledged the need for uniformity between the federal and various state securities laws and among the individual states. In 1980, it enacted the Small Business Investment Incentive Act, which authorized the SEC to cooperate with associations of state securities officials to achieve greater uniformity in federal-state securities matters. Congress sought generally to encourage uniformity in federal-state regulatory standards and to reduce costs and paperwork, and it noted specific areas for increased cooperation:

1. the sharing of information regarding the registration or exemption of securities issues applied for in the various states;

2. the development and maintenance of uniform securities forms and procedures; and

3. the development of a uniform exemption from registration for small issuers which can be agreed upon among several states or between the states and the Federal Government... 53/

Recently, the SEC and the states have made an effort to coordinate certain regulatory initiatives. In March 1982, the SEC adopted Regulation D, a series of six rules which establish a regulatory system of limited offering exemptions, 54/ while in June 1982, the SEC adopted revisions to Industry Guide 5, which provides guidelines for disclosure of information by public real estate programs in registration statements and periodic reports. In both initiatives, the SEC worked with subcommittees of the North American Securities Administrators Association ("NASAA") 55/ to develop appropriate requirements that could be accepted at the state and federal levels. Although the states are considering whether to adopt rules consistent with Regulation D, and several may ultimately adopt differing rules, these projects represent significant efforts to achieve uniformity among the states and between the states and federal government.

53/ Securities Act, § 19(c).

54/ Securities Act Release No. 6389, 47 Fed. Reg. 11,251 (1982) (to be codified at 17 CFR §230.501-.506 (1982)). For a discussion of Regulation D, see "Reducing Costs Associated with Securities Regulation", supra text accompanying notes 36-37.

55/ NASAA is a voluntary organization composed of securities regulatory agencies of 49 states, the Commonwealth of Puerto Rico, and Guam, as well as Mexico and 13 provinces of Canada.

3. Recommendation

The state securities administrators, through NASAA, should develop and each state should adopt: (1) a uniform exemption at some level similar to Rule 504; and (2) uniform limited offering exemptions identical to Rules 505 and 506 of Regulation D.

Regulation D is a series of six rules that, taken together, establishes a cohesive system for regulating limited offerings of securities. However, the benefits of Regulation D would be unavailable if the changes were not also implemented at the state level. Consequently, the SEC and a subcommittee of NASAA coordinated for several months to develop a regulation which would serve as the basis for a uniform federal-state exemption.

At its April 1982 meeting, the North American Securities Administrators Association, endorsed a form of uniform limited offering exemption ("ULOE") that is intended to coordinate with the federal regulation under Regulation D and be uniform among the states. It has as its base, Rule 505, with, however, several possible alternatives to, and variations of, the base rule. These variations include the imposition of additional conditions, and alternative conditions to Rule 505, including limitations on sales commissions or compensation, knowledge and sophistication tests for accredited and non-accredited purchasers, suitability requirements, state disqualification provisions, and state notice requirements.

In addition, the ULOE does not provide for state exemptions similar to Rules 504 and 506. Rule 504 was not the focus of the joint SEC-NASAA deliberations. However, it represents a significant advance for start-up and smaller businesses, allowing them to raise a substantial amount at

minimal costs. Rule 506, which regulates limited offerings exceeding $5 million, was not included in ULOE since, in NASAA's view, it was not a small business exemption and, thus, beyond the jurisdiction of the subcommittee to recommend.

The built-in alternatives and variables of ULOE, and the failure to include any form of Rule 504 or Rule 506 exemption, most likely will result in the adoption by the states of numerous and inconsistent versions of the ULOE and, as a practical matter, negate the benefits of Regulation D. Accordingly, it is recommended that the state securities administrators, through NASAA, should develop and each state should adopt: (1) a uniform exemption at some level similar to Rule 504; and (2) uniform limited offering exemptions identical to Rules 505 and 506. The recommendation would extend to issuers the substantive benefits of Regulation D on a uniform basis. Also, the significant legal costs incurred in conducting a state-by-state determination of the available exemption would be avoided, as well as the expense related to merit reviews in those states where the offering currently would not be exempt. The reduction in the cost of capital formation in terms of time and dollars would be substantial.

The recommendation recognizes that certain states may not wish to adopt a Rule 504 exemption with a maximum offering amount of $500,000. Accordingly, provision is made for the adoption of a lower ceiling amount.

E. CHANGES IN CORPORATE TAX RATE AND BRACKETS TO ASSIST SMALL BUSINESS CAPITAL FORMATION AND RETENTION

1. Statement of the Issue

The cost and availability of capital plays a key role in the ability of a business to succeed in its start-up years. After a business is established, capital cost and availability are often prime determinants of its ability to grow at a reasonable rate. Historically, the prime sources of capital for small business have been personal funds, bank loans and retained earnings. However, as debt/equity ratios increase, borrowing becomes increasingly more difficult and greater reliance is placed on internally generated funds. Accordingly, the ability of a small business to retain earnings is crucial in determining the availability of funds to finance growth.

Erosion of retained earnings by corporate over-taxation can materially inhibit small business expansion, particularly in light of the difficulties often faced in obtaining adequate external capital. Although corporate tax rates have historically been graduated, inflation has more than doubled price levels in the past few decades, forcing firms into higher tax brackets. Therefore, consideration should be given to modifying the current corporate tax rate and bracket structure in order to assist small business capital formation and retention.

2. Background

For all but nine of the past 73 years since the enactment of the corporate income tax in 1909, corporate profits have been exempt from tax or subject to graduated corporate tax rates. At the outset, $5,000 was exempted from the 1% levy, and an exemption applied for most of the early years, expiring for the last time at the end of 1931.

Graduated rates have existed continuously since 1936, and, in 1938, the dividing line between "large business" and "small business" was established at $25,000. After multiple-step rates during the 1940s, a two-step structure consisting of a "normal tax" (on all earnings) and a "surtax" (above $25,000) was inaugurated as part of the Revenue Act of 1950. The purpose of this differential has always been to enable new and/or smaller business to finance growth through internally generated funds.

1950 to Present: 56/ From the Korean War years until 1963, the normal corporate tax varied between 30% and 26% with the surtax at a constant

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56/ Summary of Changes (1950-85): The recent changes in the small business brackets and rates are shown in the following table:

BRACKET AND RATE CHANGES SINCE 1950

	1950-63	1963-74	1975-78	1978-81	1982	1983 (and after)
zero to $25,000	26%	22%++	20%	17%	16%	15%
$25,000 to 50,000	48%+	48%++	22%	20%	19%	18%
$50,000 to 75,000	48%+	48%++	48%	30%	30%	30%
$75,000 to 100,000	48%+	48%++	48%	40%	40%	40%
Over $100,000	48%+	48%++	48%	46%	46%	46%

\+ plus additional taxes re: Korean War ranging up to 52%.
++ plus Viet Nam surcharge of 10% expiring July 1, 1970.

22%, for a total high bracket rate ranging from 48% up to 52%. In 1963, small business advocates in Congress succeeded in reversing the rates applicable to the "normal" and "surtax" categories. Accordingly, the tax on the first $25,000 in earnings came down from 26% to 22%, although the rate above $25,000 remained at 48%.

Restoration of Graduated Rate Structure (1975): In response to the 1974-75 recession, Congress approached consideration of the emergency Tax Reduction Act of 1975 with the intention of stimulating the economy. Congress created a second low bracket, from $25,000 to $50,000. The rate on the zero to $25,000 bracket was dropped from 22% to 20%, and the $25,000 to $50,000 bracket was given a 22% rate. This was enacted on a temporary basis 57/, but the same structure was extended to 1976 and 1977. 58/ Thus, during the 1975-78 period, the corporate income tax structure consisted, in effect, of three brackets: 20% on the first $25,000 of earnings, 22% on the next $25,000, and 26% additional surtax on amounts above $50,000 for a high-bracket tax rate of 48 percent.

In connection with a 1978 Administration tax reform initiative, Senator Gaylord Nelson, Chairman of the Senate Small Business Committee, introduced a bill (S. 2669; March, 1978) proposing a 6-step corporate rate graduated to $150,000.

57/ Tax Reduction Act of 1975, Pub. L. No. 94-12 (1975).

58/ Tax Reform Act of 1976, Pub. L. No. 94-455 (1976).

In August 1978, the House accepted a progressive structure with minor modifications by adopting an explicitly graduated system in the corporate area along the lines of the graduated system which has existed in the individual area for many years.

Congress approved five steps in the rates, as follows:

1. the first $25,000 of taxable corporate income would be taxed at 17%;
2. the second bracket, from $25,000 to $50,000 would be taxed at 20%;
3. the third bracket, from $50,000 to $75,000 at 30%;
4. the fourth bracket, from $75,000 to $100,000 would be 40%;
5. all taxable income in excess of $100,000 would be taxed at 46%.

This formulation, representing the most gradations in the tax (with the possible exception of 1936-37) was signed into law as part of the Revenue Act of 1978. 59/

Further Development (1981): This remained the law until 1981, when two proposals for further extending the graduated corporate rate structure were considered. The House Ways and Means Committee offered to double the bracket levels over a two year period (50% per year) while leaving the rates constant. 60/ This would have produced a corporate tax structure beginning in 1983 as follows: 61/

59/ Pub. L. No. 95-600 (1978).

60/ H.R. 4242, 97th Cong., 1st Sess. (1981).

61/ See H.R. Rep. No. 201, 97th Cong., 1st Sess. 100 (1981).

Bracket	Tax Rate
0 to $50,000	17%
$50,000 to $100,000	20%
$100,000 to $150,000	30%
$150,000 to $200,000	40%

The Joint Tax Committee estimated this proposal would save corporations $11.9 billion for 1981-1986, approximately 97% of which would go to companies with taxable incomes below $200,000.

The Senate Finance Committee reported a proposal to reduce the rates in the two lowest brackets by 1% per year beginning in 1982, while leaving the bracket structure constant. The estimated revenue effect for this alternative was a loss to the Treasury of $2.4 billion over the 1981-86 period. The House of Representatives accepted the Senate bill which was enacted into law as part of the Economic Recovery Tax Act of 1981. 62/

Importance of Graduated Rate for Small Business and the Economy

Numerous studies, including the landmark work by Harvard Business School professors Butters and Lintner, 63/ establish the critical impact of graduations in the corporate income tax on retained earnings, and rates of return of new and small enterprises.

Earnings are a primary source of growth capital for smaller firms since traditional sources of capital are generally unavailable. For

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62/ Economic Recovery Tax Act of 1981 ("ERTA"), Pub. L. No. 97-34 (1981).

63/ Butters and Lintner, "The Effect of Federal Taxes on Growing Enterprises," Harvard Business School (1945).

example, rules of thumb in the financial industry are that, with certain exceptions, a firm must achieve pre-tax earnings of about $500,000 to qualify for an offering of equity securities to the organized regional or specialized securities markets, and about $1 million in pre-tax profits to qualify for a general public offering of equity securities by a national underwriter. Further, debt securities of extended maturities are conventionally offered in minimums of $25 million and, by definition, smaller firms have not reached that scale of operations.

The re-examination of the corporate graduated rate structure is not new. This issue was considered by the delegates to the White House Conference on Small Business in 1980. The ten regional caucuses to that conference produced various proposals for a graduated corporate tax system. Delegates proposed raising the present $100,000 ceiling to amounts ranging from $200,000 to $1,000,000. Others suggested that amounts ranging up to the first $100,000 should be exempt from tax. Finally, the conference considered indexing corporate rates to counter the erosive impact of inflation. Under all the proposals, the overall effective tax rate would be sharply reduced. Modifications to the corporate rate structure, including a corporate surtax threshold of $500,000, were voted the most important recommendation at the conference.

The following proposals are designed to amend the corporate tax rate and bracket structure in order to better achieve its intended purpose of assisting small and growing enterprises in retaining the capital needed for growth and continued vitality.

3. Recommendations

Recommendation (1) - Congress should modify the present corporate income tax rate and bracket structure. The highest corporate tax rate should apply to corporate taxable income of over $500,000 as contrasted with $100,000 at present. The lowest tax bracket should be increased substantially from its present $25,000 level, without increasing the 15% rate applicable after 1982. Other graduated tax brackets below $500,000 should be established.

Small businesses rely on internally generated funds to provide capital for growth to a greater extent than most corporations. The application of the current 46% rate above the $100,000 level creates an impediment to the creation of working capital and the financing of capital assets necessary for growth. Companies with taxable income in the $100,000 range generally do not have access to equity capital and, depending on the type of business and the suitability of current and capital assets as collateral, may have difficulty obtaining adequate bank financing. It is important to note that these small businesses, which historically have generated much of the economic growth, job creation and technological innovation in our economy, are currently starved for capital. Many small and growing companies generate significant taxable income, but have difficulty finding capital for growth. Under a revised bracket structure, companies such as these would retain the needed capital to finance job generation and expansion.

This proposal could create jobs not only in the small businesses benefitted by this additional capital infusion, but also throughout the economy, given the general economic stimulus provided by small business growth.

The proposed change in the bracket structure would also make formation of, and investment in, small businesses more attractive to entrepreneurs and investors.

While this proposal would initially result in an apparent revenue loss through the reduction of corporate taxes, additional tax revenue will result from the direct job creation in those companies and their accelerated growth. Since each percentage increase in unemployment costs the federal government billions in expenditures and lost revenues, the long-range effect of this proposal should be a net revenue increase.

Recommendation (2) - Congress should give consideration to the following:

A. That small corporations be entitled to income average in the same manner individuals income average;

B. That the accumulated earnings tax exemption be raised from its present level of $250,000;

C. That dividends be deductible, to some extent, provided that they are reinvested in small business; and

D. That a small business data base be developed so that the significance of small business to the U.S. economy and the effect of proposed tax changes can be more accurately determined.

The intent of the first three recommendations is to encourage and facilitate the retention of badly needed capital by small and emerging businesses. The revenue impact of any modifications in these areas is unknown given the lack of available data.

The lack of available data regarding small business serves as the basis for the final recommendation. That recommendation contemplates the development of a data base in order that both legislators and regulators can better determine the needs of the small business community and assess the impact of legislative and regulatory initiatives on small business concerns. 64/

64/ The participants at the Forum voted on this proposal on the grounds that these are corporate tax matters worthy of Congressional consideration and review. Since the participants did not have the time necessary to assess the ramifications or parameters of any specific changes, the proposal is broadly worded as a request for Congressional review.

F. CHANGES IN THE TAX TREATMENT OF CAPITAL GAINS TO PROVIDE A STIMULUS TO CAPITAL FORMATION, PARTICULARLY FOR SMALLER BUSINESSES.

1. Statement of the Issue

Historically, the level of investment and risk-taking has been sensitive to the effective capital gains tax rate. A lower tax rate for long-term capital gains has played a significant role in stimulating higher levels of investment and promoting an inflow of funds to new and emerging businesses. Conversely, high tax rates on long-term capital gains have been accompanied by a fall-off in investment activity, particularly with respect to small businesses. Since small business investments are generally long-term, illiquid and have a recognized possibility of partial or total loss, investors require significant returns before committing funds to such high-risk ventures. Accordingly, given the need for greater investment activity, particularly with respect to small businesses, consideration should be given to various changes in the tax treatment of capital gains. These changes would provide a stimulus to capital formation in general, and would increase investment activity in the small business sector, thereby strengthening the economy's potential for growth and job creation.

2. Background

History of Capital Gains Taxation 65/ - From enactment of the income tax in 1913 until 1921 there was no statutory capital gains provision, with

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65/ See Exhibit D, Table 1 for a tabular presentation of the capital gains changes through 1981.

all recognized gains being taxed at ordinary income rates. The Revenue Act of 1921 introduced a definition of capital asset and provided special treatment for gains if the asset was held for more than two years. This two-year holding period was in force until 1934, when it was reduced to one year. From 1934-1937, long-term capital gains were taxed on a four step sliding scale system, with the percentage of the gain (or loss) includible in the tax base dependent upon the length of time the asset was held. The longer the asset was held the smaller the portion of the gain included in taxable income. The Revenue Act of 1938 substituted a two step sliding scale and imposed a minimum holding period of eighteen months. The effective tax rate was 20% on assets held 18-24 months, and 15% on assets held more than two years. The Revenue Act of 1942 eliminated the sliding scale and classified capital assets as either short-term or long-term. The Act dropped the holding period for long-term gain to 6 months and required 50% of the gain to be included in the tax base for individuals (100% in the case of a corporation). An alternative rate of 25% was available for both individuals and corporations. This system predominated from 1942 - 1969, although minor changes were made to the alternative rate and loss provisions.

The Tax Reform Act of 1969 effected several restrictive provisions in the capital gains area. That Act restricted the use of the alternative tax rate to $50,000 of capital gains, with any excess gains being subject to the regular rates. At that time, one-half the gain was deductible and the maximum regular marginal rate was 70% resulting in an increase of the effective maximum capital gains rate from 25% to 35%. Additionally, the

Act also imposed a 10% minimum tax on "tax preferences" exceeding $30,000, which included the untaxed portion of net capital gains. Thus, in some instances, the minimum tax further increased the effective tax rate on capital gains by 5%. The combined effect of the alternative rate and minimum tax changes was an increase in the maximum capital gains rate from 25% to 40% (a 60% increase). Further, the Act cut the available offset for capital losses by 50% by providing that only one-half of long-term capital losses could be used to offset ordinary income. The stated purposes underlying these changes were a redistribution of the tax burden in a more equitable manner, and a limitation on the tax advantages accruing to corporations and high-bracket taxpayers.

The Tax Reform Act of 1976 imposed further restrictive changes on the taxation of capital gains. The holding period was raised from 6 months to 1 year. The minimum tax rate was increased from 10% to 15% with the exclusion on the amount of preference income (e.g., long-term capital gain) which may be realized without being subject to the minimum tax being reduced from $30,000 to $10,000. Due to the combined effect of the capital gains tax, the minimum tax, and maximum tax, the effective tax rate on capital gains climbed to 49.125%. For corporations, the rate was lower at 37.50%. At the same time, the period the investment must remain at risk was doubled when the holding period was extended from 6 months to one year.

The only rationale advanced for doubling the holding period was: (1) special long-term capital gain treatment should be afforded only those who realize gains on assets held for investment, and not speculative profit (the implication being that one who holds for six months, as opposed to 12 months, is primarily interested in obtaining quick gains from short-

term market fluctuations); and (2) special capital gain rates are prescribed in recognition of the fact that the realized gain is attributable to appreciation in value over a long period of time, and, accordingly, should not be taxed at individual progressive rates as though earned in the current year.

There was a groundswell of opposition to the high tax rates on long-term capital gains and a movement in Congress to restore the benefits effaced by the 1969 and 1976 Acts. In 1978, Congress passed the Revenue Act of 1978 which effected crucial reverses in the trend toward overtaxation of capital. The Act increased the long-term capital gains deduction from 50% to 60%, thereby reducing the maximum effective tax rate on such gains to 28%. For corporations the alternative tax rate was reduced to 28%. The stated rationale for these changes was that the high level of capital gains tax contributed to a slower rate of economic growth and a shortage of investment funds needed for new and small businesses and for capital formation purposes generally. 66/ The House Ways and Means Committee stated that these changes would increase savings and lead to more business investments, greater productivity, and higher wages.

Even before the full effects of the 1978 Act reductions were felt, the tax rate on long-term capital gain was further reduced pursuant to the Economic Recovery Tax Act of 1981 ("ERTA"). That Act reduced the top marginal rate from 70% to 50%, thereby reducing the maximum effective

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66/ H.R. Rep. No. 1445, 95th Cong., 2d Sess. 119 (1978).

rate on capital gains from 28% to 20%. The holding period remains at one year.

Capital Formation Trends - While trends in capital formation are influenced by a wide variety of factors, the level of capital gains tax undoubtedly plays a significant role in an investor's assessment of the potential rewards for investment and risk-taking. There is strong evidence to support the proposition that the increases in the capital gains tax implemented by the Tax Reform Acts of 1969 and 1978 discouraged productive investment by implementing a bias in the tax system against savings, investment and risk-taking. For example, the increases in the capital gains taxes in both 1969 and 1970 were accompanied by large declines in the stock market and a reduction in the shareholder population. Additionally, first time common stock offerings by fledgling businesses declined dramatically from 1969 - 1978. 67/ Moreover, new capital committed to venture capital firms plunged from $171 million just prior to the tax increase of 1969 to $39 million in 1977. The levels rose in late 1978 after it became clear that the capital gains taxes would be reduced. 68/ Further, small companies suffered since, as indicated on Table 3, venture capital disbursements remained flat until 1979 when the benefits of the tax cuts were fully realized.

67/ The number of first-time issues dropped from 1,298 in 1969 to 58 in 1978. See Exhibit D, Table 2.

68/ See Exhibit D, Table 3. The table reflects estimated funding and disbursements from 1969 - 1981 noting the capital gains tax changes.

Statistics from a wide variety of sources indicate that the 1978 capital gains tax cut served as an extremely effective stimulus to investment and bolstered the economy in an otherwise difficult economic period. As noted above, and reflected in Table 3, there has been a remarkable inflow of funds to venture capital firms and record setting disbursements to portfolio companies. Additionally, a 1980 New York Stock Exchange study 69/ reveals that between 1975 and 1980, the stockholder population rose by 4.6 million to 29.8 million (a 18.1% increase) reversing a decline in the prior five-year period. The report also shows that 22% of current stockholders are new investors, compared with 9% in 1975. Further, the NYSE found that after the tax cuts took effect, 130,000 new investors entered the stock market in an average month, compared with 86,000 in previous months. NYSE Chairman William M. Batten attributed much of this increased activity to the 1978 reduction in capital gains taxes.

The increased availability of funds and demand for equity securities afforded many small companies a badly needed opportunity to raise new capital through offerings of common stock. New capital raised through initial public stock offerings of corporations climbed sharply in late

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69/ "Changing Patterns in the Public Ownership of U.S. Corporations," New York Stock Exchange (1980), As described in Captial Formation, Vol. 6, No. 1, American Council for Capital Formation (January 1981).

1978, and dramatic gains were reported in 1979 and 1980. 70/

Lowering the capital gains tax has had a unique cost savings aspect in that the estimated total gains realized, and taxes paid on capital gains income, rose from the figures in 1978. 71/ Additionally, statistics published by the Treasury Department on March 20, 1981, reveal that the higher capital gains tax receipts in 1979 were largely or completely derived from higher realization by the highest income groups. 72/

The final results on the cost of the 1978 capital gains tax reduction, if any, are not in since the higher capital gains tax receipts may be temporary based on a non-recurring realization of capital gains induced by that tax measure. However, it seems axiomatic that when tax policy encourages investments in equities, venture capital, and taxable debt obligations the federal government revenues, based on dividend, interest and capital gains taxes, should rise given a reasonable level of economic growth and business success. Alternatively, when investment and capital gains taxes are high, the flow of money to equity, venture, or risk

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1975	1976	1977	1978	1979	1980
$265	$234	$153	$250	$506	over $1 billion

Note: Amount in millions
Source: Going Public, as reprinted in The 1978 Capital Gains Tax Reduction: Progress Report II, Oscar S. Pollock, Ingalls & Snyder (January 23, 1981). This report further notes that in 1978 and 1979 the new capital derived from venture capital firm disbursements and initial stock offerings was almost $2.5 billion ahead of the comparable 1976-1977 total.

71/ See Exhibit D, Table 4. Estimates stated are as of March 20, 1981.

72/ See Exhibit D, Table 5.

capital investments is shifted to tax shelters, municipal or other tax-free obligations, and tangible assets all of which are more difficult to tax or are exempt from taxation. Accordingly, federal tax policy should encourage greater investment levels by all taxpayers, and especially those with significant capital resources. Such a policy would increase the available pool of funds for investment in the innovative small business sector and strengthen the economy's potential for growth and job creation at a minimal, if any, cost to the treasury.

3. Recommendations

Recommendation 1 - Congress should amend the Internal Revenue Code to provide an investment tax credit, equal to 10% of funds invested, for investment in a "Qualified Small Business Investment" (QSBI).

A. Such credit would not be available for any investment if the source of such funds is the sale or other liquidation of a prior QSBI in a transaction occurring fewer than a specified number of years prior to the date of the new investment;

B. The capital gains tax otherwise payable with respect to any investment liquidations, upon election, shall be deferred on the portion of the capital funds which are reinvested in a QSBI within a certain period of time from the date of the transaction producing such capital gain. The tax may be deferred until a subsequent QSBI investment is liquidated, or until the date of liquidation of the last QSBI investment in a chain of transactions; and

C. A "Qualified Small Business Investment" would be:

(1) An equity security or debt instrument issued by a Small Business Investment Company, Business Development Company, or a small business as determined by reference to the SBA small business size standards for SBIC investments;

(2) An equity security or debt instrument which does not permit the investor to require the repayment thereof sooner than five years after the date of the investment; provided that a debt instrument may provide for a minimum five year amortization; and

(3) In the case of a debt instrument, one which provides for interest not to exceed the then current federal financing bank rate.

Gains realized from the sale for cash of equity investments in qualifying enterprises are recognized and taxed under the capital gains provisions, provided the investment represents a capital asset. This is true even if the proceeds are reinvested immediately in another qualifying enterprise. However, if the investor acquires solely voting stock in exchange for his equity securities, and the tax-free reorganization provisions of the Code are satisfied, no gain or loss is recognized even if the securities acquired are readily marketable and thus equivalent to cash. As a result, tax policy encourages the absorption of the smaller independent businesses by merger or stock-swap. Additionally, an investor who recognizes taxable capital gain will, after payment of the tax, have fewer dollars available for the support of other qualifying enterprises. Accordingly, consideration should be given to a proposal which allows for an investment tax credit and permits an investor to rollover gains provided the proceeds are reinvested in qualifying enterprises. This permits deferral of the tax liability until such time as the funds are no longer devoted to the support of such entities.

There is ample precedent for both the investment tax credit concept and tax deferral on rollover of a capital investment. With regard to the rollover, reinvestment in a new QSBI is at least as beneficial to our economy than the similar treatment afforded homeowners on the sale of a residence.

The goals of this legislation would be twofold:

a) to attract new capital to small businesses through the investment tax credit; and

b) to encourage funds already committed to small business investments to be reinvested in such companies when the original investment is liquidated. The tax deferral also would increase the amount of funds available for reinvestment when the source of funds is a capital gain transaction.

The predominant advantages to this type of proposal include the following. The capital gain tax deferral would provide incentive to investors in a qualifying enterprises to roll-over their portfolios more often and reinvest the proceeds of the sales in other qualifying enterprises, the effect of which would be increasingly greater capital committed to the small business sector of the economy. The provision would reduce the tax code's inducement to owners of small businesses to sell out to large corporations, whose shares are actively traded, in tax-free reorganizations so that they can postpone capital gains tax on the sale. Further, small businesses that approach potential investors for funding would be assisted by such legislation. Banks, SBICs, venture capital funds, and other institutional lenders would benefit from the incentive of the tax credit and from the tax deferral. Individual investors now investing funds in tax shelters or money market funds would have greater incenti to invest at least a portion of their funds in small businesses. Owner-investors would be able to commit greater amounts of funds to their businesses. New investments stimulated by this legislation would result in the creation of new jobs and, ultimately, increased tax revenues from both the businesses and newly employed workers.

The QSBI definition is based on the definition for eligible SBIC investments but deletes the prohibitions against investing in affiliates.

Recommendation 2 - Congress should amend the Internal Revenue Code to provide that after holding an equity or equity-type investment made directly in a small business for more than five years, the seller of such an investment would be entitled to exclude 80% of any gain realized on such investment.

Current law regarding the taxation of long-term capital gains requires that an investment be held for more than a year before the investor qualifies for lower tax rates on his profits from investment. In the general explanation of the Tax Reform Act of 1976, which increased the holding period to one year from 6 months, the Joint Tax Committee noted the following: (1) Congress believed there should be special tax treatment for gains on assets held for investment, and not speculative profit, and that one who holds an asset for a short time is primarily interested in obtaining quick gains from short-term market fluctuations; and (2) that the six-month holding period was not a remedy for the "bunching problem". 73/

Recent legislative initiatives have been proposed to reduce the holding period to 6 months, 74/ or eliminate it totally. 75/ The report of the Senate Finance Committee states the rationale behind the proposal to shorten the holding period is that the change would increase capital market efficiency and reduce the lock-in effect on investors who do not desire to realize short term gains. This same rationale was advanced in

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73/ The bunching problem may be described as follows. It would be unfair to tax an individual in a single year at progressive rates on a profit that was earned over many years.

74/ H.R. 4961, 97th Cong., 2d Sess. (1982); S. Rep. No. 494, 97th Cong., 2d Sess. Vol. 1 (1982). This provision was not part of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, H.R. Rep. No. 97-760, 97th Cong., 2d Sess. (1982).

75/ S. 2530, 97th Cong., 2d Sess. (1982).

support of the bill which would eliminate the holding period requirement. An additional reason advanced for elimination of the holding period is a simplification on the tax law.

This system ultimately may serve to disadvantage small enterprises. If long-term capital gains can be achieved with a six-month investment in a relatively risk-free "blue chip" stock, why would an investor purchase equity securities of a small enterprise when risks are higher and realization of benefits may take years?

In the interest of rewarding realized gains accrued over an extended period, which is a primary purpose behind long-term capital gains treatment, consideration should be given to establishing a two-tiered holding period system with the capital gains deductions increasing to 80% if the investment is held for five years.

The advantages to establishing this type of system are several. First, the system would introduce a better balance between risk and reward. Second, the system would spur risk-taking and encourage longer term investments, which are the type needed for development and growth. Third, this system would more adequately address the bunching problem since the individual's tax liability in the year of realization would be adjusted to recognize that the profit was earned over an extended period of years. Fourth, investment in new and small businesses would be promoted since realization of gains from such venture capital investments require an extended holding period. Fifth, since investors would have greater incentive to realize longer term capital gains than current income,

businesses would be encouraged to plow back earnings to achieve greater growth rather than disbursing their earnings to pay dividends. Sixth, to the extent equity financing is more readily available, the debt-equity ratio on corporate balance sheets should improve, thereby reducing the risk associated with the investment. Finally, this system confers additional benefits for longer term investments, while preserving the current system for investments of a lesser duration.

> Recommendation 3 - Congress should amend the Internal Revenue Code to provide that any long-term capital gain realized upon the sale of an equity or equity-type investment made directly in a small business (as defined by the regulations of the Small Business Administration) shall be taxed to a corporation at the maximum effective rate applicable to an individual for an identical investment.

Under current law, individual taxpayers may deduct from gross income 60% of the amount of any net capital gains for the taxable year. The remaining 40% of the net capital gain is included in gross income and taxed at the otherwise applicable income tax rates. As a result, without considering the alternative minimum tax, the highest tax rate applicable to an individual taxpayer's net capital gain is 20% (50% top tax rate on the 40% includible capital gain). A corporation with long-term capital gain has a choice under present law: it may pay taxes on the gain at ordinary income tax rates running from 17% to 46% or it may pay an

alternative rate of 28%. Accordingly, corporations realizing net capital gains are disadvantaged vis-a-vis individuals since the top corporate rate remains at 28%. 76/

In order to encourage greater investments in small businesses by venture capital and other corporations consideration should be given to reducing the corporate alternative rate to 20% when the gain is realized upon the sale of an equity or equity-type investment in a small business. Additionally, fairness dictates this change in order that capital gains realized by a partnership and passed through to the partners not be taxed at rates lower than those applicable to a business organization formed as a corporation.

> Recommendation 4 - Congress should amend the Internal Revenue Code to eliminate the ($50,000/$100,000) limitation on loss deductions for §1244 small business stock. Corporations should be eligible for §1244 ordinary loss treatment. The stock limitation for §1244 corporations should be increased from $1 million to $5 million. Corporations and individuals should be allowed to take ordinary loss deductions on all instruments (i.e., debt, preferred stock and guarantees, as well as common stock) used to invest in §1244 corporations.

Section 165(g)(1) of the Internal Revenue Code provides that if a security (defined to include stock, bonds and other evidences of indebtedness) which is a capital asset becomes worthless during the taxable year, the loss shall be treated as though it had arisen on a sale or exchange thereby creating a capital loss. Several exceptions to §165(g)(1)

76/ See discussion accompanying and following note 66, supra.

were created in 1958 as part of legislation designed to encourage investments in small businesses. 77/ One such exemption is Section 1244. The provisions of that section are designed to encourage investments in small business concerns by permitting loss on Section 1244 stock issued to individuals or a partnership, which would generally be treated as a capital loss, to be treated as an ordinary loss. There are numerous limitations on the use of Section 1244 which, if modified, could significantly enhance the flow of venture capital to small and emerging businesses. Further, since investors in such enterprises are vitally interested in downside risk, more attractive loss provisions will attract additional capital by favorably altering the risk/reward ratio.

Recommendation 5 - Congress should pass legislation providing that the deductibility of interest paid on loans incurred to invest directly in small businesses (as defined by SBA) should be unlimited.

Currently under Section 163(d) of the Internal Revenue Code the amount of investment interest 78/ allowable as a deduction is limited to $10,000 (for a joint return) plus the amount of net investment income. 79/

77/ Sections 1242 and 1243 provide ordinary loss treatment for certain losses attributable to investments in and investments by small business investment companies. Section 1244 provides, under limited circumstances, ordinary loss treatment for losses attributable to certain investments in defined small businesses

78/ I.R.C. Section 163(d)(3)(D) defines investment interest to mean interest paid or accrued on indebtedness incurred to purchase or carry property held for investment.

79/ I.R.C. Section 163(d)(3)(A) defines net investment income. Generally, it means gross income from dividends, interest and other investment income less expenses directly connected with the production of investment income. See also I.R.C. Section 163(d)(3)(B) and (C).

The proposal being advanced is based on the premise that an individual is often required to borrow money in order to provide additional equity capital to the corporation. Since small enterprises rarely pay dividends, small business persons do not realize net investment income from their corporations and, accordingly, are generally limited to a deduction of $10,000. This proposal would carve out an exemption from the general limitation of Section 163(d) for interest payments with respect to money borrowed for investments made directly into small businesses. The proposal would increase the incentive to continue to fund small businesses during the start-up and/or growth phases.

> Recommendation 6 - Congress should pass legislation providing that an individual investor with a substantial equity in a small business, who completely sells his shares in the business, may elect a one time exclusion of a percentage/dollar amount of any long-term capital gain realized thereby, if such investor has attained the age of 65 and has held his investment for 10 consecutive years preceding the sale.

Many small business persons finance their ventures during the start-up phase with funds from their own resources, family members, friends and neighbors, and other local businesspersons, i.e. attorneys, dentists, doctors, etc.

This recommendation will attract additional sources of capital for small businesses by offering the substantial investor a greater incentive, i.e. the potential to earn large amounts of the tax free income at an age when the investor may be considering retirement. The recommendation also recognizes that many small business persons, who have expended tremendous resources building a business, view the equity in that corporation as their prime source of retirement income.

The concept of Recommendation 6 is comparable to provisions in Section 121(b) of the Internal Revenue Code which permits homeowners to exclude $125,000 of gain on the sale of a home if certain requirements are satisfied, such as attaining age 55 and the home having been the principal residence for a specified period of time prior to the sale.

G. ADDITIONAL TAX MODIFICATIONS

1. Statement of the Issue

Various provisions of the Internal Revenue Code and regulations currently serve to discourage investments in, and the operation of, small business concerns. To the extent these disincentives can be identified, various regulatory and legislative proposals should be endorsed in order to enhance the vitality of the small business community. The following recommendations represent five specific areas which have been identified as being ripe for change and which could significantly assist in small business capital formation and retention.

2. Recommendation 1 (§385 Debt/Equity Regulation) - Section 385 of the Internal Revenue Code should be repealed and existing case law and guidelines should be used to distinguish debt and equity for tax purposes. However, should Congress, for policy reasons, determine repeal of Section 385 is undesireable, the Treasury Department should be encouraged to adopt broad safe harbors for small businesses under the Section 385 regulations, which are easy to understand and apply, including:

   A. An exemption from the regulations for corporations with less than $1 million in debt held by shareholders;

   B. A shareholder debt to equity ratio safe-harbor of 5 to 1, replacing the 3 to 1 safe-harbor in previous versions of the regulations;

   C. Exemption from regulations for corporations during the first five years of their existence;

   D. Use of market value rather than book value of corporate assets for purposes of applying the safe-harbor, at the election of the corporation or instrument holder; and

   E. Review of the application of the regulations to investments with conversion features.

The question of whether advances to a corporation are to be treated as debt or equity for federal income tax purposes has been one of the most frequently litigated issues in the tax law. The vast majority of these cases raised the issue of whether the payment by the corporation to the security holder is a deductible interest payment or non-deductible dividend distribution. Over the years the courts have resolved the issue on an ad-hoc basis. The situations in which this issue arises are disparate and the courts have not established rigid formulas or litmus paper tests. In an attempt to develop guidelines and factors for resolving this issue, Congress, as part of the Tax Reform Act of 1969, added Section 385 to the Internal Revenue Code. Realizing the difficulty in drafting a comprehensive debt-equity scheme, Congress in Section 385 authorized the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated as stock or indebtedness. However, although the issue is the subject of continuing debate, many contend that neither Section 385 nor the recently released regulations lend clarity or certainty to a debt-equity determination. Additionally, both impose undue burdens on capitalizing and organizing small businesses. Accordingly repeal of Section 385 is recommended.

However, if the statutory provision is determined by Congress to be necessary, the proposal recommends that the Treasury Department provide limited exemptions and safe harbors in order to reduce the impact these regulations would have on the small business community.

Small business organizations and others have supported such an approach noting that: (1) these regulations, if implemented, would have a chilling effect on small business capital formation; and (2) since the regulations are tax neutral the limited exemptions and safe harbors being proposed would not disrupt the current efforts to reduce the federal budget deficits.

3. Recommendation 2 (Subchapter S) - Congress should (in addition to HR. 6055) continue to study liberalization of Subchapter S, including the adoption of legislation:

   A. Allowing more than one class of stock for Subchapter S corporations;

   B. Allowing partnerships, corporations, and trusts to be shareholders of Subchapter S corporations;

   C. Increasing the number of shareholders in a Subchapter S corporation to as many as 100;

   D. Allowing Subchapter S corporations to form DISCs; and

   E. Increasing the number of days during the taxable year for electing Subchapter S to as many as 240 days.

Subchapter S of the Internal Revenue Code, enacted by Congress in 1958, permits a limited pass through of income and loss to the shareholders of a closely-held corporation. The objectives of the legislation were to minimize the effect of federal income taxes on choices of the form of business organization, and to permit the incorporation and operation of certain small closely held businesses without the incidence of income taxation at both the corporate and the shareholder levels. However, some of the present rules are unduly restrictive and create traps for small businessmen who are not entirely familiar with their provisions or who do not obtain tax advice.

For this reason the small business community strongly endorsed H.R. 6055, which simplifies a great many provisions of Subchapter S. However, additional modifications which expand the availability and utility of Subchapter S are encouraged.

For example, paragraphs A and B, above, would allow a small business which has elected Subchapter S treatment to retain that status even though it obtained additional growth capital from a small business investment company, or similar venture capital firm, which traditionally employs hybrid securities in financing investor companies. Paragraph C, above, endorses the concept that Subchapter S should be available only for small, closely-held corporations. However, the current restriction of 25 shareholders, as well as the H.R. 6055 provision allowing 35 shareholders, is believed to be unduly restrictive and fails to recognize that corporations may remain family or closely-held with as many as 100 shareholders.

The other modifications being recommended are intended to expand the availability and utility of Subchapter S to a greater number of small businesses.

4. Recommendation 3 (Jobs Tax Credit) - Congress should restore permanently the general jobs tax credit as originally enacted in the Tax Reduction and Simplification Act of 1977.

Under present tax law, the Targeted Jobs Tax Credit (TJTC) is available to firms which hire individuals from one or more specified

economically disadvantaged groups. 80/ TJTC has been criticized by small business groups as not being particularly useful because it is considered too detailed, limited, and complex.

When orginally adopted in 1977, the jobs tax credit was broader, imposing but a few limitations on its availability and use. Its intended purpose was to reduce the level of unemployment in the economy as a whole by providing labor intensive industries an incentive to increase employment activity. This general jobs tax credit was restricted in 1978 and again in 1981 on the ground that the unemployment rate had declined sufficiently so that it was appropriate to focus employment incentives on those individuals and groups who had high unemployment rates or special employment needs. Given the high unemployment rate in today's economy, continuation of the TJTC, in lieu of a general jobs tax credit, should be reconsidered.

Moreover, 97% of small businesses are labor intensive. They are primarily service related firms such as retailing, wholesaling, restaurants, and other service oriented firms which can put marginal workers to productive use. With the discontinuance of the general job tax credit, small businesses,

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80/ I.R.C. Section 51 provides that an individual is a member of a targeted group for purposes of TJTC if that individual is:

(1) A vocational rehabilitation referral;
(2) An economically disadvantaged youth;
(3) An economically disadvantaged Vietnam-Era veteran;
(4) An SSI recipient;
(5) A general assistance recipient;
(6) A youth participating in a cooperative education program;
(7) An economically disadvantaged ex-convict;
(8) An eligible work incentive employee; or
(9) An involuntarily terminated CETA employee.

which historically provide a significant percentage of the nation's employment, have been forced to eliminate marginal positions to the detriment of those who would otherwise be gainfully employed. A general jobs tax credit would provide a significant incentive for small businesses to generate additional jobs.

5. Recommendation 4 (Accounting Methods) - Congress should amend the Internal Revenue Code to allow businesses with less than $3,000,000 in annual sales to elect for tax purposes either the cash receipts and disbursements method or the accrual method of accounting.

The general rule for methods of accounting provides that taxable income must be computed under the same accounting method which the taxpayer regularly utilizes to compute his income in keeping his books. Section 446 of the Internal Revenue Code prescribes the permissable methods of accounting and recognizes that no uniform method can be applied to all taxpayers. Accordingly, that section permits the taxpayer to compute taxable income under any of the following accounting methods:

1. Cash receipts and disbursements method;
2. Accrual method;
3. Any other method permitted under the Tax Code; and
4. Any combination of the above.

Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income, are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made. Generally under the accrual method,

income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy. Deductions are allowed for the taxable year in which all the events have occurred which establish the expenditure and the amount can be determined with reasonable accuracy.

The cash receipts and disbursements method may not be used, however, in any case in which it is necessary to use an inventory. 81/ Under these circumstances the accrual method of accounting is required.

The taxation of a corporation based on the accrual method of accounting disproportionately impacts small business concerns since it extracts capital when most needed to finance start-up costs, inventory accumulation, and needed receivables. Often the result is early failure of desirable small businesses.

The proposal carves out a small exception which recognizes small businesses are often cash poor and have limited access to credit. Cash basis accounting under these circumstances, by allowing the accumulation of inventory and receivable accounts without incurring an immediate tax liability, may permit growth through the start-up phase and could result in the retention of badly needed cash. At $3,000,000 annual sales level the problem would still exist, but the business should be creditworthy enough to convert to accrual accounting and survive.

6. Recommendation 5 (Incentive Stock Options) - Congress should revise the incentive stock option provisions of §422A of the Internal Revenue Code including the following:

81/ Treas. Reg. 1.446-1(a) and (c).

A. Increase the §422A(b)(8) ceiling limitation of $100,000 in order to permit appropriate equity opportunity necessary to attract key employees capable of contributing to the growth of an emerging company.

B. Eliminate the sequential exercise rule prescribed in §422A(b)(7).

C. Modify the Tax Equity and Fiscal Responsibility Act of 1982 in order that the exercise of an Incentive Stock Option will not give rise to an item of tax preference under the alternative minimum tax provisions scheduled to go into effect December 30, 1982.

The Economic Recovery Tax Act of 1981 introduced Section 422A of the Internal Revenue Code entitled Incentive Stock Options ("ISO"). This provision was an outgrowth of the restricted stock option and the qualified stock option, which were repealed in 1964 and 1976, respectively.

The intent behind the introduction of the ISO was to provide corporations with an incentive device for attracting new management and retaining the services of executives who might otherwise leave. This is accomplished by providing key employees with an opportunity to acquire an equity interest in the business, thereby instilling the incentive to help build a successful enterprise with an expanding and improving profit position.

In general, there are no immediate tax consequences to the grant or execise of an ISO. The employee is taxed at capital gains rates when the stock received on the exercise of the option is sold. Accordingly, no business expense deduction will be allowed to an employer with respect to an incentive stock option. Finally, the difference between the option price and the fair market value of the stock at the exercise of the option will not be an item of tax preference for computing the alternative minimum tax.

With respect to the last provision, the Tax Equity and Fiscal Responsibility Act of 1982 will revise the law, effective December 30, 1982. That Act provides that with respect to the transfer of an ISO, the amount by which the fair market value of the share at the time of exercise exceeds the option price is an item of tax preference for computing the alernative minimum tax. This provision was not in the bill as originally drafted, and was added without commentary in the conference agreement.

Several modifications to the ISO provisions could significantly assist small businesses. For example eliminating the sequential exericse rule of Section 422 A(b)(7) will allow an employee of a small business to select the best option, which in turn increases the effectiveness of the ISO in attracting qualified personnel. In this regard, the management personnel of small business often times receive minimal salary and bonuses, and forgo other compensation opportunities in order to assist an emerging enterprise through its growth stage. The elimination of the sequential exercise rule would allow that employee to select the best available option and thereby realize long-awaited benefits.

Additionally, the $100,000 limitations of Section 422A(b)(8) should be substantially increased. That provision provides that the term "incentive stock option" means an option granted to an individual in connection with his employment but only if the aggregate fair market value of the stock for which the employee may be granted in any calendar year does not

exceed $100,000. An amendment which raises the $100,000 limitation would permit cash strapped small businesses to attract qualified personnel without paying currently the salary and bonuses commensurate with their abilities. Small enterprises historically have been disadvantaged vis-a-vis large firms and the government given the higher risks and their reduced ability to offer competitive salary, bonuses, perquisites and other benefits.

Finally, the alternative minimum tax provision in the Tax Equity and Fiscal Responsibility Act of 1982, discussed above, should be modified. Incentive Stock Options to be effective must be large enough to attract desired personnel, must be flexible enough to achieve the desired results, and must not have an immediate tax impact. The committee report on the Economic Recovery Tax Act of 1982 specifically provided that the exercise of the option would not give rise to an item of tax preference. Although not discussed in the committee report, the amendment in the new law is presumably a revenue raising measure, and the effect upon enterprises and small business was probably never considered. The employee attracted by the ISO rarely has significant cash reserves to pay the required tax associated with the exercise of the option. Since exercise of the option may be cost prohibitive, this provision would detract from the incentive to associate with an emerging growth company. Delay of tax liability until the recipient sells the stock underlying the option, and can thereby raise the cash needed to pay the tax, is critical.

H. FEDERAL SMALL BUSINESS CREDIT ASSISTANCE PROGRAMS AND OTHER MATTERS RELATING TO SMALL BUSINESS ACCESS TO CREDIT

1. Statement of the Issue

A. The Federal government impacts on small business lending most directly through credit assistance programs. All but one of the government's small business credit assistance programs are administered by the Small Business Administration ("SBA"). While credit assistance programs involve only a small percentage of all bank small business lending, their impact is not insignificant. Improvements in these programs could lead to greater and more effective utilization by banks and small business, and thus more significant impact on the small business sector of the economy.

B. Small, locally owned and controlled banks provide a large proportion of SBA guaranteed as well as other small business loans. However, the financial services industry in general and commercial banking in particular is in the early stages of a major restructuring. Statutory and regulatory changes are being considered which could lead to a reduction in the number of small banks. There is a question as to whether such changes would adversely affect small business access to commercial bank credit.

2. Background

As of the close of of fiscal year 1980, the total amount of direct loans and loan guarantees outstanding as a result of SBA small business credit assistance programs was $9.2 billion. (Unless otherwise noted,

all data on SBA programs has been supplied by SBA). In a recent survey, bankers estimated that. as of June 30, 1981, small business loans outstanding at the nation's banks totaled approximately $120 billion. 82/ By this rough measure, SBA loan guarantees appear to be applicable to about 7.6% of small business lending by commercial banks. Moreover, commercial bankers believe they meet approximately 72% of the total credit needs of small business which suggests that the total credit outstanding for small business is roughly $166 billion. 83/ Accordingly, it can be estimated that SBA loan programs are impacting on about 5.5% of all institutional small business lending. 84/

While SBA's share of total loans and investment funds advanced under its programs has grown in dollars from $1.37 billion in fiscal 1972 to $3.39 billion in fiscal year 1981, almost all of that growth had occurred by the end of fiscal year 1977. Moreover, in terms of constant dollars adjusted for inflation, growth over the period 1972-1981 has been rather small.

The statutory bases for general small business credit assistance programs are the Small Business Act as amended 85/ and the Small Business Investment Act of 1958 as amended. 86/ The Small Business Act

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82/ C. Glassman and P. Struck, Survey of Commercial Bank Lending to Small Business, (1982). The survey was conducted for the Interagency Task Force on Small Business Finance and is included in its recent report, Studies of Small Business Finance (1982).

83/ Id.

84/ It is estimated that SBA programs account for about 4% of total funds raised by small business. See D. Hansen, supra note 1.

85/ P.L. 85-536 (July 18, 1958)

86/ P.L. 85-699 (August 21, 1958)

was designed to ensure the vitality of the private enterprise system by promoting free competition through the creation, preservation, and growth of small business. In addition, it mandates a Federal policy that fosters business ownership among individuals who own and control little productive capital. The Small Business Investment Act was designed to improve the national economy through programs that stimulate the flow of private equity capital and long-term loan funds to small business concerns. This policy is to be carried out to ensure the maximum participation of private financing sources.

SBA offers a variety of loan programs to eligible small businesses. The agency makes some direct loans, but the vast majority of loans are made by private lenders and are partially guaranteed by SBA. SBA financial assistance programs include regular business loans, handicapped assistance loans, loans to small business located in areas of high unemployment or owned by low income individuals, energy loans, and development company loans. SBA also has substantial programs for disaster loans and surety bond guarantees and a small program involving pollution control bonds to which the discussion which follows does not pertain.

A direct loan involves SBA making a loan directly to the business applicant, without the utilization of an intermediary financial institution, and immediate participation loans involve SBA and a private lending institution each advancing a portion of the loan. In the case of a guaranteed loan, a private financial institution makes the entire loan and SBA guarantees up to 90% of the loan against default risk. If there should be a default, the SBA bears the liquidation burden. Today, the SBA

is authorized to guarantee up to $500,000 of each loan. Interest rates on guaranteed loans are not permitted to be more than 2-1/4% above prime for term loans of less than seven years and 2-3/4% above prime for longer term loans. As a practical matter, the interest limits have tended to be a floor as well as a ceiling with respect to money center bank lending, while non-money center banks have tended to set interest rates more closely based on local cost of money. In recent months, non-money center bank SBA loans have averaged as low as prime plus 1%.

In fiscal 1981, SBA had available $4.9 billion to make direct and guaranteed business loans. Actual loans made in fiscal 1981 totaled $3.4 billion. In fiscal year 1980 SBA had available about $4 billion to make direct and guaranteed loans. Actual loans made in fiscal 1980 totaled $3.6 billion. Between fiscal 1980 and 1981 the number of SBA loans decreased from 31,519 to 28,650. These figures reflect an increase in the average size of loans approved in 1981. Average loan size in 1981 was about $118,457.

In recent years, over 80% of all SBA approved business loans have been granted through the Section 7(a) program, which encompasses loan guarantees and direct loans made to individual small businesses through commercial lenders or SBA. During that time, guaranteed loans typically have accounted for over 90% of all 7(a) loan approvals. For example, in fiscal 1981, only $219 million was available for direct or immediate participation loans under the 7(a) program. Direct and immediate participation loans may be completely phased out by fiscal 1983. Accordingly, the main focus of the Forum was guaranteed general business loans under Section 7(a).

In addition, the Forum considered and made recommendations concerning SBA's 503 Development Company Program and the SBIC program. The SBIC program is the only venture capital program sponsored by the Federal government. Under the program SBA licenses, regulates and provides leverage to privately owned investment companies which select small business concerns to be financed. The 503 program utilizes a new method of funding in providing assistance to development companies. Instead of direct and guaranteed loans, Certified 503 Development Companies issue debentures which are guaranteed by SBA and sold to the Federal Financing Bank. The CDC must furnish 10 percent of the project's cost and 50 percent of the project's financing must come from non-federal sources. In fiscal 1981, there were 186 guarantee commitment approvals totaling $34.4 million of which 33 totaling $5.2 million were sold through the Federal Financing Bank.

3. Recommendations

Recommendation 1 - Congress should authorize SBA to permit revolving credit arrangements and other normal commercial loan accommodations in connection with small business loan guarantees.

Revolving credit and other normal commercial loan accommodations are practical means of providing for the working capital needs of many small businesses. Longer term asset financing, which is the current thrust of SBA loan guarantee programs, is increasingly available through lease arrangements and other means but, the working capital needs of many small businesses are periodic and cyclical and are not efficiently met through longer term loans. Many small businesses get locked into multi-year term loans guaranteed by SBA because revolving credit and other commercial loan accommodations are unavailable with SBA guarantees. As a result, small businesses may be incurring excessive interest expenses

as a result of long term loans not tailored to their specific needs. As with larger businesses, the working capital needs of small business can be more efficiently met through revolving credit and other normal commercial loan accommodations which should entail lower long term cost and reduced risk to the lender.

Recommendation 2 - Congress should raise the SBA's loan guarantee limit to $1,000,000.

When the loan guarantee program was first adopted in 1953, the loan guarantee limit was set at $150,000. Subsequently, the limit was raised in several steps, to $500,000 in 1976 where it stands today. Inflation has severely eroded the value of $500,000 since 1976 and an increase to $1,000,000 would help to keep pace with inflation.

The average SBA loan guarantee is not near the present ceiling and is estimated at about $130,420 based on fiscal year 1981 data. Moreover, few loans are made at the ceiling. In part, this is the result of a philosophy at SBA that favors spreading available loan guarantee money among many rather than making larger loans to fewer businesses. If SBA were to orient itself more toward assisting small businesses in high growth industries where capital needs are intensive, such a strategy would yield the largest returns in terms of job creation and capital formation, two key goals of national economic recovery. Moreover, in connection with the previous recommendations that SBA permit revolving credit agreements, raising the loan guarantee limit would facilitate SBA's participation in offering small and growing businesses a fuller range of financial services which are vital to their continuance and successful growth.

Recommendation 3 - Recognizing that SBA loan guarantee programs are a direct and cost-effective means of creating jobs and assisting our nation's economic recovery Congress should increase SBA's loan guarantee authority. Continued support of the SBA's loan guarantee programs will protect the integrity of the secondary market for the guaranteed portion of the loan. In addition, Congress should expand the SBIC and 503 programs.

While reduction of Federal deficits is of primary importance to the nation's economic future, SBA loan programs, with their relatively small costs and high potential for stimulating economic growth, appear to be a cost-effective investment for the government. For example, the actual loss rate on the SBA guaranteed loan portfolio is 4.14%, and the ultimate loss rate which considers provisions for future losses is estimated at 9.83%. In fact, SBA has determined that the real cost to taxpayers in fiscal year 1981 of its guaranteed loan program was $242 million.

A secondary market in SBA guaranteed loans has been promoted and developed by SBA in cooperation with private sector lenders and broker/dealers to provide liquidity for lenders in SBA's 7(a) guarantee program. During fiscal 1981, 2500 loans were sold in the secondary market for approximately $450 million, thus freeing funds for additional financing of small business concerns. This $450 million represented about 17% of SBA's 7(a) guarantee activity for the year. The Forum participants believe that continued congressional support for the 7(a) program is necessary to preserve the integrity of the secondary market.

The Forum participants believe that in addition to enhancing SBA's loan guarantee authority and for similar reasons Congress should provide additional fu ling for the SBIC and 503 programs. Since the beginning of the program 22 years ago, about 46,000 small businesses have received

$4 billion in SBIC financing. Because of the demonstrable cost efficiencies of the program, the Forum believes that Congress should increase funding for this program.

In addition, as part of this recommendation the Forum voiced support for the 503 Development Company Program. However, the Forum also endorsed a separate recommendation concerning the 503 programs discussed herein.

> Recommendation 4 - The SBA should reduce extensive paperwork, and time delays and simplify complex approval procedures which have characterized the loan guarantee program in the past. In this regard, the Certified Lenders Programs and non-bank lending programs should be accelerated and expanded to the extent possible.

One of the most common complaints about SBA loan guarantee programs expressed both by lending institutions and small business borrowers concerns the time delays, extensive paperwork and complex approval procedures which have characterized SBA's programs in the past. In an effort to be responsive to such complaints, SBA piloted the Certified Lenders Program ("CLP") in 1979. The CLP is available to lenders who have demonstrated a commitment to enhancement of small business firms in their local communities, who have exhibited a willingness to cooperate with their local SBA offices and most importantly who have had a successful record of making and servicing SBA loans. Under the program, SBA delegates to these lenders many of the authorities and responsibilities currently vested in the SBA, which allows SBA to provide lending approval in three days. The result is improved and faster service to small business clients.

During fiscal year 1981, the SBA expanded its Certified Lenders Program to include an additional 249 lenders, resulting in a total participation of 500 lenders (all but one are commercial banks.) Although most of 249 participants were certified only during the final three months of the fiscal year, SBA approved 3,674 business loans under the auspices of the CLP during fiscal year 1981.

As it expands and develops, the CLP should result in less duplicative work by certified lenders and the SBA, freeing up SBA resources for work on matters other than loan casework. For example, SBA could assign more of its resources to intensive servicing of "troubled" loans, to working with noncertified lenders to help them qualify for SBA certification, to small business advocacy endeavors and to SBA outreach efforts aimed at locating additional sources of small business capital.

There are several advantages to the CLP program: reduced time delays for processing SBA guaranteed loans, reduced cost to SBA in guaranteeing such loans, and an enhanced relationship between lender and borrower. Accordingly, the program should be encouraged and expanded as quickly as possible.

Recommendation 5 - The SBA should permit interest rates on guaranteed loans to be based on local primes or indices.

In the vast majority of cases, private lenders charge small business customers higher interest rates than those charged large borrowers. In the case of SBA guaranteed loans, current SBA policy permits interest rates to run as high as 2-3/4% over the New York prime rate.

While public policy may dicate that the government impose a ceiling on the permissible interest rate which can be charged on SBA guaranteed loans, the requirement that interest rates be pegged to the New York money center banks prime may be counterproductive and unnecessary. Most small business lending is carried out primarily by smaller banks, the vast majority of which are not in New York. A New York prime does not necessarily accurately reflect the cost of money to such institutions. Accordingly, requiring small banks to peg their loan rates to the New York prime is not a sound business practice and makes the process of negotiating a fair rate more difficult.

Banks that are not located in money centers generally have available either local primes or indices more accurately reflecting their cost of money. Permitting the use of such local measures would encourage SBA guaranteed lending and remove a degree of interest rate volatility, since local primes typically fluctuate less than the New York prime. Although the use of locally based rates would not necessarily reduce borrowing costs over time, greater interest rate stability would be a benefit to both borrowers and lenders.

> Recommendation 6 - In an effort to increase bank and small business participation in the SBA loan guarantee program, it is recommended that a survey of commercial bank and small business attitudes towards the SBA loan guarantee program be conducted (by an entity independent of the government) in order to identify and remove impediments to increased utilization of the program.

There are currently about 14,500 insured commercial banks in the United States of which 87.1% have assets under $100 million. As of the end of fiscal 1981, 10,536 commercial banks had at least one SBA loan

outstanding. However, of that total only 1700 banks had between 10 and 24 SBA loans outstanding and only 700 banks had 25 or more SBA loans in their portfolios. This data suggests that SBA loan programs are not widely utilized by banks and that there may not be significant competition among banks for SBA loan business. In this context, it is notable that over the past several years, SBA has not exhausted its loan guarantee authority, a fact which is only partially explained by slackening demand brought on by the recession and is particularly troublesome in the face of unmet small business credit needs and the importance of small business to our nation's economic future.

In 1981, the Federal Government's Inter-agency Task Force on Small Business Finance conducted a survey of commercial bank lending to small business. Based on responses, small business loans involving government assistance or guarantees are estimated to account for less than 15% of the average small business loan portfolio. The survey further found that, although most bankers know something about SBA and believe SBA is at least somewhat effective in educating them, most say SBA could improve its programs. The improvements often suggested are more efficiency in processing paperwork and approving loans and increased communication with and counseling of banks. It is suggested by the survey data that, if improvements were made, an estimated two-thirds of the banks would increase their usage of the program.

While this survey data is a useful starting point, more information on bank and small business utilization of the SBA loan guarantee program is necessary to identify steps to improve usage of the program and

importantly for small business borrowers, to enhance bank competition for SBA guaranteed loan business. Increased lender competition combined with reduced loan processing costs would be expected to lower interest rates and improve the terms of such loans to a point that is commensurate with the minimum exposure which banks have under the program.

> Recommendation 7 - The SBA 503 Program is strongly supported as an important tool for long term fixed asset funding of small business expansion. The program should be supported by sufficient SBA staff and debenture guarantees authority to meet the loan demands of the certified development companies. SBA communication with its certified development companies and the National Association of Development Companies should be encouraged. It is recommended that a ten year debenture be permitted as well as 15, 20 and 25 years debentures.

SBA's 503 Development Company Program assists communities, both urban and rural, to stimulate the growth and expansion of small business through the active professional and management services offered by a Certified Development Company (CDC). A CDC must have a defined area of operation, and must be representative of the community or region in which it operates. In addition, it must have the capability to package, process, close and service its loans, and must maintain a place of business accessible to small businesses.

Through this joint federal and private sector program, financing for up to 25 years is provided to small business concerns for the acquisition of land and buildings, construction, expansion, renovation and modernization and the purchase of machinery and equipment.

This program is seen as the most viable way for SBA to provide assistance to development companies in future years. The program would be enhanced by increased funding and staff and increased dialogue with CDCs and their representatives. In addition, the SBA should permit a

10 year debenture as well as 15, 20 and 25 years debentures which are currently permitted. A ten year debenture would provide greater flexibility to CDCs and enhance their appeal to investors. Such a change is justified in the context of rapidly changing economic conditions.

> Recommendation 8 - Industrial revenue bonds (IRBs) are a significant factor in the capital expansion of business. Accordingly, the current tax exempt status of small business IRBs should be preserved and the sunsetting of IRB tax benefits is opposed. Current federal policy prohibits many agencies such as SBA, EDA and FMHA from participating in projects financed in part by industrial revenue bonds. However, larger businesses receiving federally supplied Urban Development Assistance Grant assistance may use these bonds with this program. Policy should be changed to permit SBA and other agencies to participate with industrial revenue bonds in the same project. This will put small businesses on the same footing as larger companies not requiring such assistance. To enhance small business utilization of IRBs, the Internal Revenue Service should allow packaging of small IRB issues into one large issue.

Industrial revenue bonds can be an important financing source for small business. However, current SBA Standard Operating Procedures for the Section 503 program prevent subordination of Section 503 debentures to first mortgage financing that is tax exempt. The SBA is urged to reverse this policy because it is inconsistent with other federal programs, arguably contrary to the intent of Congress and unjustifiably prejudicial to small business.

Other federal programs permit and in fact encourage subordination of federal loan programs to tax exempt financing in order to provide the best financing for the designated project. The Department of Housing and Urban Development's Urban Development Assistant Grant program, and others permit subordination to tax exempt financing.

In addition, one indication of the intent of Congress is expressed in the Conference Report to S.2698, The Small Business Development Act of 1980 87/ wherein it states "SBA should not disapprove the guarantee of any debenture, or any loan made with the proceeds of a debenture issue, solely because the proceeds would be used in a project whose other sources of financing include, or are collaterized by, tax exempt industrial revenue or development bonds."

Finally, current SBA policy may be viewed as prejudicial to smaller businesses as large businesses are able to combine federal financing with tax exempt financing in many cases. As an advocate for small business, SBA should be seeking to provide opportunities for small business which are commensurate with those of larger enterprises.

Recommendation 9 - While there is a need to revise some regulations governing the financial services industries to make them more responsive to changes in technology and a changing economy, it is important that any legislation dealing with the financial services industry consider the needs of the small and medium sized financial institutions which traditionally finance small business.

Small, locally owned and controlled banks currently serve the credit needs of small business better and to a greater extent than larger financial institutions. As noted previously, banks with less than $100 million in assets provide over three-fourths of all small business loans. Also, a recent survey of small business persons by the National Federation of Independent Businesses revealed that by a margin of 4 to 1, small business people prefer to deal with small, locally owned banks. The survival of such small banks is threatend by a major trend toward the concentration of the nation's financial institutions. A reduction in the number of small,

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87/ S. 2698, Con. rep. 96-1087, p. 32 (1980).

locally owned banks could result in a reduction of financial services and access to credit for small business. Accordingly, it is recommended that Congress consider carefully the impact on small business access to credit of legislation which could affect the structures of the financial services industry in general and the viability of small banks in particular. 88/

88/ This recommendation resulted from a minority report of the credit drafting group. The report contended that our present banking system has by and large served our nation well, that it did not evolve in the free market, but as a result of federal and state legislation enacted to provide a safe and sound banking system which meets the needs of a diverse economy. The minority report concluded, that it is not likely that small banks would exist in a political environment which does not specifically provide for their existence.

There appeared to be a majority view among the participants that small banks today are doing a better job of serving the needs of small business than larger banks. However, the Forum was positively disposed toward banking deregulation to enhance competition in the financial services industry. To the extent that deregulation would lead to a reduction in the number of small banks, there was less than a consensus as to whether Congress should continue to prevent market forces from determining the structure of the financial services industry.

IV. FORUM PARTICIPANTS

A. Participants Other Than Accountants and Lawyers in Private Practice

Dr. Barry R. Bronfin
Scientific Leasing, Inc.
Farmington, Connecticut

Founder and CEO of a corporation which leases high-technology systems to hospitals and R & D organizations.

James H. Carrington, Ph.D.
Seasonair Management Corporation
Rockville, Maryland

Small businessman and former academician. Member of the SBA's National Advisory Council.

John Caulfield
Committee on Small Business
U.S. House of Representatives
Washington, D. C.

Associate Counsel, Subcommittee on Tax, Access to Equity Capital, and Business Opportunities. Formerly an attorney with Small Business Administration.

Rick Centner
Department of Health
and Human Services
Washington, D. C.

Special Assistant for Public Affairs to Assistant Secretary for Human Development Services. Previously Minority Counsel to House Subcommittee on Tax, Acces to Equity Capital, and Business Opportunities; Legislative Director for David Marriott, U.S. House of Representatives. Frequent speaker on issues involving small business and the involvement of disadvantaged groups in the establishment of small business enterprises.

Alan Chvotkin
Committee on Small Business
U.S. Senate
Washington, D. C.

Minority Chief Counsel. Previously Majority Legal Counsel, Senate Committee on Small Business; professional staff member, Senate Budget Committee and Senate Committee on Governmental Affairs.

Thomas M. Clark, President
Michigan Rivet Corporation
Warren, Michigan

Currently Vice Chairman of the National Association of Manufacturers, Subcommittee on Corporate Governance. (Since 1980) Subcommittee is responsible for NAM policies related to SEC regulation, corporate finance and management, and any legislative or regulatory initiatives impacting upon manufacturers in those areas.

Alan H. Cohen
Ithaca College - School of Business
Ithaca, New York

Associate Professor of Accounting and Small Business, and Director of the college's Small Business Institute. CPA engaged in small business consulting.

Dr. Morton Collins
DSV Partners
Princeton, New Jersey

General Partner and founder of DSV Partners, a venture capital investing firm. Chairman, National Venture Capital Association. Member, Governor's Commission on Science and Technology - New Jersey.

William L. Crolley
Transact Industries, Inc.
Woodstock, Georgia

Small businessman with experience with the SBA loan program, Form S-18 and Regulation A filings.

Richard H. Cummings, Jr.
Alliance Enterprise Corporation
Philadelphia, Pennsylvania

Venture capital investor who, since 1977, has served as president of Alliance Enterprise Corporation, a wholly owned MESBIC subsidiary of Sun Company, Inc. Serves on the Board of Governors of the National Association of Small Business Investment Companies. Also served as president/director of the American Association of MESBIC's and as a member of the Capital Formation Committee of the White House Conference on Small Business, 1980.

Lyle W. Davis
Wilson-Davis & Co., Inc.
Salt Lake City, Utah

A financial principle of a small regional self-clearing broker-dealer that has been the primary underwriter for many start-up companies. Served on the NASD District Business Conduct Committee and National Uniform Practice Committee.

Jan Donovan
Small Business Institute
Arizona State University
Tempe, Arizona

Director of the Small Business Institute at Arizona State University. Member, Small Business Committee of the ABA Corporation, Banking and Business Law Section. Instructs students in the Masters in Business Administration Program in the areas of Business Management and SBA programs.

C.C. Elebash
University of W. Florida
Pensacola, Florida

An Associate Professor of Finance. Served as a trustee of a public pension fund.

Frank B. Fairbanks
Horix Manufacturing Company
Pittsburgh, Pennsylvania

President of the Horix Manufacturing Company since 1968, prior to that, Vice President since 1957. Also member of Board of Directors and President of Smaller Manufacturers Council. Member of Taxation Committee of the Pennsylvania Chamber of Commerce and the National Association of Manufacturers.

David E. Franasiak
U.S. Chamber of Commerce
Washington, D. C.

Director of the Tax Policy Committee of the U.S. Chamber of Commerce.

Arthur Frigo
Super-Cut
Chicago, Illinois

President, Super-Cut, a manufacturer of industrial diamond products. Member, Diamond Wheel Manufacturers Institute, Industrial Diamond Association, Presidents Forum, and Young Presidents Organization. MBA Instructor, Lake Forest College.

Stanley Fulwiler
Tapecon, Inc.
Peachtree City, Georgia

President, Chairman of the Board and founder of Tapecon, Inc., a manufacturer of pressure sensitive labels and tags. Vice President, Georgia Small Business Council. Held positions of secretary and director of Small Business Administration - Southeast.

Peter W. Gavian
Corporate Finance of Washington, Inc.
Washington, D. C.

President of Corporate Finance of Washington, Inc., a company which specializes in private placements and venture capital financing.

Joe Geneser
Vernon Company
Newton, Iowa

Immediate past chairman of Specialty Advertising Association International, a trade association representing over 2700 small business firms. Currently serving as Executive Vice President and Director of a publicly held company. Also serving on the board of a commercial bank and the Iowa Business Development Credit Corporation.

Howard T. Glover
Conneaut Savings & Loan Company
Conneaut, Ohio

20 years experience in the savings & loan industry. Chairman, Small Association Committee of United States League of Savings Associations which represents over 3,000 small savings & loans. Member of the National Advisory Council of the Small Business Association.

Benson Goldstein
Committee on Small Business
U.S. House of Representatives
Washington, D. C.

Counsel, Subcommittee on Tax, Access to Equity Capital and Business Opportunities. CPA and attorney; previously with Internal Revenue Service and tax specialist with Touche Ross & Co.

Donald J. Goniu
Olympic Supply Company
Milwaukee, Wisconsin

Vice President and General Manager of a bicycle wholesale distributorship. Delegate to Governor's Conference on Small Business, serving on two committees: (1) Capital Formation; and (2) Retention and Regulation.

Marcia Grad, President
Mohawk Research Corp.
Highland Park, Illinois

Founder and President of Mohawk Research Corporation, a closely-held technology development company. Previously a research scientist at Denver Research Institute. Annual attendee of "Setting the Research Agenda," a small business conference. Member of the International Council of Small Business and the New Product Development Association.

John Green, President
J.G. Industries, Lee Company
Stillwater, Oklahoma

Founder of J.G. Industries, a closely-held corporation. Member of the Small Business Advisory Council of the Stillwater Chamber of Commerce.

Steven D. Gurian
The Money Store of New York, Inc.
Mineola, New York

President of the Money Store of New York, Inc.; Executive Director of Long Island Development Corporation & Long Island Economic Development Corporation; and member U.S. Small Business Administration Advisory Council for New York State.

Brian Hartman
U.S. Senate Committee on
Small Business
Washington, D. C.

Financial Analyst with the Senate Committee on Small Business. Formerly with Peat Marwick & Mitchell with a specialty in small business tax and auditing.

E.F. Heizer, Jr.
Heizer Corporation
Chicago, Illinois

A venture capital investor who, prior to founding Heizer Corporation, was with Allstate Insurance Company with responsibility for the Private Placement Division.

Harold L. Henning
Scientific Advances, Inc.
Columbus, Ohio

Vice-President and General Counsel for Scientific Advances, Inc. Responsible for structuring investments in growth oriented high technology companies, providing advice during growth, and disposing of those investments. Spent several years practicing law with a specialty in advising small and closely held business.

Georgia L. Holmes
Assistant Professor
Business Administration
Mankato State University
Mankato, Minnesota

An associate professor in the University's School of Business who also works with the University's Small Business Development Center. Member of the Small Business Committee of the ABA Corporation, Banking and Business Law Section. Engaged in the private practice of law representing clients in setting up small businesses.

Durant A. Hunter, Vice President & C.D.O.
James Hunter Machine Co., Inc.
North Adams, Massachusetts

Presently running a small family business. Previously worked at Morgan Guaranty Trust for six years.

Joseph J. James
Philadelphia Citywide Development Corporation
Philadelphia, Pennsylvania

Local government official.

J. Michael Jarvis
Jarvis Corporation
Richmond, Virginia

Chief executive of a family business for the past twelve years.

John Rucker Jones, SRS
Rucker Associates, Ltd.
Arlington, Virginia

A regional vice president of the Real Estae Securities and Syndication Institute. Serves as an assistant instructor for the Institute, and vice chairman of its Professional Standards Committee.

George Kevorkian
G.K. Scott & Co., Inc.
Melville, New York

President of a small, full-service stock brokerage firm specializing in small over-the-counter issues. Previous experience in public and private accounting.

Charles Lea
Dillon Read & Co.
New York, New York

Managing Director. Head of the Venture Capital Group. Formerly managing director of New Court Securities. Director of Burkhart Petroleum Corporation, Damon Group, Monolithic Memories, Inc., Oximetric, Inc., and the Rome Group, Inc. Founder and past Chairman and President of Venture Capital Association.

Baxter Lee, CBSE, Vice President
Building Service Contractors Association International
Fairfax, Virginia

Has developed a building service contracting firm and a multiple unit restaurant firm. Both these firms have grown by adding new branches and units through acquisitions and mergers.

Helen Krause Leslie
K & W Supply House, Inc.
St. Petersburg, Florida

A small businessperson who has served as a member of the SBA's National and Regional Advisory Councils, as a member of the U.S. Senate Advisory Council to the Small Business Committee, and as a Trustee of the Small Business Association.

Joel Levitt
Springfield Controls Corp.
Doylestown, Pennsylvania

Founder of Springfield Controls, Corporation. Member of the National Small Business Association, Trustee, and past President and Director of the National Family Business Council.

Arthur Lipper, III., President & CEO
Arthur Lipper Corporation
New York, New York

An international investor and financier venture capitalist and investment consultant. President and CEO of Arthur Lipper Corporation which includes world-wide affiliates and subsidiaries. Also chairman, New York & Foreign Securities Corporation and trustee, the Lipper Foundation.

Frank E. Marley, Jr., Administrator
Oklahoma Securities Commission
Oklahoma City, Oklahoma

Appointed Administrator of the Oklahoma Securities Commission in September, 1978. Member of the Board of Directors and First Vice President of the North American Securities Administrators Association. Member of the National Association of Securities Dealers' Direct Participation Program Committee. Previously, Chairman, Midwest Securities Commission Association. Member of the Arbitration Board of the Better Business Bureau; lectures before local business organizations.

Maj. General R.E. Mason, Jr., President
AUS - Retired
Columbus Truck & Equipment Company
Columbus, Ohio

Owner and President of the Columbus Truck & Equipment Company and the Bode-Finn Co. Iargest stockholder in First National Bank of Venice (Fla.). Consulting director BancOhio; consultant and former director to motor transportation companies, and investor and director Ronweber Furniture Company, Batesville, Indiana.

Judith A. McGough, Director of Finance
Allentown Economic Development Corporation
Allentown, Pennsylvania

Finance director for a private, non-profit economic development corporation, administering Certified Development Company financing programs for small businesses under the Small Business Act. Also provides technical assistance and loan packaging and placement services for small businesses utilizing SBA, FHMA, County and State Industrial Development Authorities, convention financing institutions, and venture capital resources.

Arthur Morgan, President
Artmor Plastics Corporation
Cumberland, Maryland

Founderand President Artmor Plastics Corp; Participated in numerous Department of Commerce foreign trade seminars; appointed to White House Small Business Conference; Director, Small Business National Unity Council. Recently appointed to Export Council.

Glen S. Morris
Morris Securities, Ltd.
Chicago, Illinois

A registered broker-dealer and investment advisor and member of the NASD. A specialist in private placements with extensive experience in tax shelter syndication and financial analysis and advising.

Mark S. Munn, CEO
Brady Energy Corp.
Pompano Beach, Florida

Prior to joining Brady Energy Corporation in January, 1982, Mr. Munn was the General Partner from 1979-1981 of four limited partnership drilling funds. From 1974-1979 he was President of the Investment Advisory Division of Legg Mason Wood Walker, Inc., a member firm of the New York Stock Exchange.

Marjorie E. Nesbitt
Citibank, N.A.
New York, New York

Manager of closely held business assets held in estates and trusts. Participated in acquiring and retaining capital and credit through industrial revenue bonds, accounts receivable financing, state economic development agencies, venture capital, and public markets.

Robert A. Newman, Executive Vice President
Scioto Economic Development Corporation
Portsmouth, Ohio

Involved in Business Development Financing, including EDA Revolving Loan Programs, State Loan and Grant Programs, Federal Loan and Grant Programs, SBA 503 Debentures, and Industrial Development Programs.

Judith H. Obermayer, Ph.D., Vice President
Research & Planning, Inc.
Cambridge, Massachusetts

Specialist in high technology enterprise development. Completing a study of "Small High Technology Companies and National Objectives During a Period of Severe Debt and Equity Shortages." Conducted workshops on funding technological development and commercialization. Over 15 years experience with Moleculon Research Corporation as Controller and Vice President. Director of the MIT Enterprise Forum, the Massachusetts Technology Development Corporation, and the Research Management Association. Participated in the White House Conference on Small Business.

Oscar M. Olson
Small Business Unity Council
Battineau, North Dakota

A small businessman who has participated in the Federal Reserve Small Business Forum, White House Conference on Small Business, Steering Committee and Governor's Conference on Small Business. Board of Directors, North Dakota Import Dealers Association, Immediate Past Chairman North Dakota Small Business Unity Committee, and Vice Chairman Small Business National Unity Committee.

F. John Oshoway, President
Geophysical Petroleum Corp.
Spencer, West Virginia

President of a small independent oil and gas operating company actively engaged in raising capital for drilling. Member of the ABA Small Business Committee. Participant in the Homestead Small Business Taxation Conference. Also an attorney chiefly engaged in a general corporate practice.

Richard E. Peterson
SAM Associates, Inc.
Chicago, Illinois

Management consultant specializing in wholesale-distribution with broad experience in marketing and finance. Author of Working With Your Bank.

James M. Popkin
Coalition of Northeastern Governors
Washington, D. C.

Research Associate for the Coalition of Northeastern Governors (CONEG) Policy Research Center. Currently, producing a study on "Taxes and Small Business: Analysis of Federal and State Tax Policies to Promote Growth in the Small Business Sector."

Albert L. Reese, Jr.
Plumb Oil Company, Inc.
Houston, Texas

Currently Director and Vice President (Finance) of the Plumb Oil Company, Inc. Previously a partner in Arnold, Reese, Sevenson & Co., C.P.A.'s and prior to that an auditor for Peat, Marwick, Mitchell & Co. Also a financial advisor and/or director for three small businesses.

Luke Rich
New York State Senate
Albany, New York

Executive Director of the Small Business Subcommittee and since March, 1982, of the Commerce and Economic Development Committee of the New York State Senate.

Donald M. Rosenberg
Oxford First Corporation
Philadelphia, Pennsylvania

Chief Financial Officer of Oxford First Corporation, a financial services and real estate company. Previously an auditor manager with Peat, Marwick, Mitchell & Company.

Mark Sargent
University of Baltimore School of Law
Baltimore, Maryland

Professor of Law. Has worked on law reform for the state of Maryland, Maryland Securities Division.

Frank Sellers
Staff of Congressman Dennis Eckart
Falls Church, Virginia

Legislative Assistant for Congressman Dennis Eckart responsible for small business matters. Formerly Politicial News Correspondent and Broadcast News Executive in Ohio.

Bruce W. Shewmaker
Merrill Lynch Venture Capital, Inc.
New York, New York

Vice President and Director of Merrill Lynch Venture Capital, Inc. since September, 1981. Responsible for starting up Merrill Lynch's venture capital operation. Over twelve years investment experience working with an investment subsidiary of the Chase Manhattan Bank, Diebold Investment Company, a publicly-held investment company, and a venture capital operation of Time, Inc. Previously Treasurer, New York Venture Capital Forum, NASBIC and NVCA.

Richard H. Simpson, Chairman
Bennett Publishing
Peoria, Illinois

Chairman of Bennett Publishing Company. Former Chairman of National Small Business Association. Attended White House Conference on Small Business, Peoria Chamber of Commerce Small Business Group, and IBAL.

Raymond J. Skiptunis
Biosearch Medical Products, Inc.
Somerville, New Jersey

Financial Vice President of a small public company. Previously an accounting and tax instructor at Rutgers University and before that was engaged in his own private accounting practice.

John Sower, Washington Director
The National Development Council
Washington, D.C.

An economic development investment banker for NDC. NDC, a private, non-profit organization, is presently coordinating the Reagan Administration's new Small Business Economic Revitalization Program. He is also Executive Vice-President of the National Association of Development Companies.

George Spalding, President
Diemakers, Inc.
Monroe City, Missouri

Founder and President of Diemakers, Inc. Named 1980 National Small Business Person of the Year. Member of National Association of Small Business Investment Companies. Director and Executive Board member of Mid-Continent Small Business United. Board of Directors, Commerce Bank of Hannibal, Missouri.

Philip Speser, J.D., Ph. D., Executive Director
National Institute for Entrepreneurial Technology
Silver Spring, Maryland

The National Institute for Entrepreneurial Technology is a think tank and action group within Spencer Associates, a small social science based firm specializing in providing support services for innovators. Research focused on the relations of science, technology, and politics, and on small high-technology firms and university-business relations.

Wayne T. Stanford
South Central Illinios Regional Planning Commission
Salem, Illinois

Financial advisor presently working with banks and small businesses providing loan and credit analysis for preparation and submission of loan applications to the SBA. Previously spent seven years in business consulting with city government, financial institutions and small businesses.

Vincent J. Stanley
V.J. Stanley, Inc
Rochester, New York

Small businessman since 1951. Trustee, National Small Business Association (Executive Committee). Member, National Federation of Independent Business, Small Business Council of Rochester Chamber of Commerce, National Chamber of Commerce, New York State Business Council, National Association of Wholesaler/Distributors, and Family Business Council.

William R. Steiner, Executive Director
Northwest Pennsylvania Regional Planning
and Development Commission
Franklin, Pennsylvania

Responsible for the Northwest Pennsylvania Region's enterprise development program, administering a revolving loan fund and SBA 503 program.

William C. Story
Oil International, Ltd.
Denver, Colorado

Founder and President of several small companies. Former banker with small businesses lending experience. Raised capital through private placements and public offerings.

Leopold Swergold
Gintel & Co.
New York, New York

A broker-dealer for the past 15 years involved in financing small and medium-sized companies. Serves as an investment banker to several corporations.

W. G. Brooks Thomas
Development Credit Corporation of Maryland
Towson, Maryland

Development banker actively engaged in providing development loans to small businesses and making companies commercially successful.

Michael Unger, Director
Massachusetts Securities Division
Boston, Massachusetts

Government official responsible for reviewing and passing upon securities offerings which will be made to Massachusetts residents.

Carmine A. Vignola
Electronic Representatives Associations (E.R.A.)
Jefferson City, Missouri

Representative for domestic and foreign manufacturers. Served on 1980 White House Small Business Council. Member of the Board of Directors of E.R.A. (Heart of America) and the Government Affairs Chairman for the E.R.A. National Office.

James D. Vitarello
Office of the Comptroller of
the Currency
Washington, D. C.

Community Development Specialist. Attorney and Urban Planner; formerly Executive Director of the D.C. Neighborhood Reinvestment Commission Director of Finance and Housing, the President's Commission on Neighborhoods.

Sidney B. Wachtel, President
Wachtel & Co., Inc.
Washington, D. C.

President of Wachtel & Co., Inc., an investment banking firm specializing in assisting small companies since 1961. Presently a director of, or financial advisor to, approximately 15 corporations. Presently a member of the Washington Society of Investment Analysts, Security Traders Association of Washington, and the Washington Bond Club.

Edwin M. Walker, Director
Securities Division
Department of Insurance
Nashville, Tennessee

Director of the Tennessee Securities Division responsible for state regulation and policy governing the sale of securities in Tennessee. Chairman of the NASAA subcommittee on Equipment Leasing.

Phyllis Ann Webster, EdD, CPA
University of North Carolina
Greensboro, North Carolina

Academician specializing in taxes. Maintains a tax practice and is a CPA with 14 years in small accounting practice. Involved with a small Sub-S Corporation and with the Taxation Committee of the North Carolina Association of CPA's.

Daniel D. Weston
Central Corporate Reports Service, Inc. (CCRS)
Westlake Village, California

President and Chairman of the Board of CCRS, a small publicly-owned corporation which provides developmental and financial services to public and private corporations, including smaller businesses.

Valerie M. Yeager
American Security Bank
Washington, D. C.

Assistant Vice President and venture capitalist.

W.O. Young, Jr.
Young Engineering, Inc.
Spartanburg, South Carolina

Founder and President of a small engineering/manufacturing business.

B. Attorneys

Constantine Alexander
Boston, Massachusetts

Gregory Beck
Santa Ana, California

George Bermant
Denver, Colorado

Gerald Chalphin
Philadelphia, Pennsylvania

James T. Christy
Washington, D. C.

Lawrence A. Coles, Jr.
Chicago, Illinois

John F. Corrigan
Providence, Rhode Island

Harold R. Davis
Boston, Massachusetts

Richard E. Deer
Indianapolis, Indiana

Stuart M. De Haaff
Los Angeles, California

Ronald L. Fein
Los Angeles, California

Ralph C. Ferrara
Washington, D. C.

Charles D. Fox, III
Roanoke, Virginia

Conrad G. Goodkind
Milwaukee, Wisconsin

Richard B. Gossett
Chattanooga, Tennessee

George W. Hopper
Denver, Colorado

Robert S. Jaffe
Seattle, Washington

Edward E. Kallgren
San Francisco, California

Stanley Keller
Boston, Massachusetts

Donald E. Kelley, Jr.
San Francisco, California

Stephen J. Kushel
New York, New York

Richard Leisner
Tampa, Florida

Robert Mattson, Jr.
San Francisco, California

James M. Neeley
Philadelphia, Pennsylvania

Gerald V. Niesak
San Francisco, California

Charles M. Noone
Washington, D. C.

Harold S. O'Brian
Sommerville, New Jersey

Anthony R. Pierno
Los Angeles, California

Mark Rollinson
Alexandria, Virginia

Richard H. Rowe
Washington, D. C.

Thomas F. Ruhm
New York, New York

Robert Rupp
Washington, D. C.

James C. Sargent
New York, New York

Michael S. Sirkin
New York, New York

John K. P. Stone, III
Boston, Massachusetts

Gregory C. Tevis
Denver, Colorado

George W. Thibeault
Boston, Massachusetts

Robert Titus
Hartford, Connecticut

Dana L. Trier
Washington, D. C.

Benjamin Uchitelle
St. Louis, Missouri

Benjamin Vandergrift
Washington, D. C.

John C. Vincent, Jr.
Boston, Massachusetts

Thomas G. Washing
Rochester, New York

James L. Watts
Washington D. C.

Michael R. Winston
New York, New York

C. Accountants

Kenneth J. Ashcraft
San Francisco, California

Jon A. Barrows
Phoenix, Arizona

Diane C. Blount
Atlanta, Georgia

Bruce S. Botwin
Cherry Hill, New Jersey

Charles Chazen
Los Angeles, California

Irwin Diamond
Albuquerque, New Mexico

William E. Dunbar
Indianaplis, Indiana

Walter Farley
New York, New York

James J. Hand, III
New Orleans, Louisiana

Earl D. Harriman
Long Beach, California

James Hoover
Buffalo, New York

Alfred M. King
New York, New York

Richard A. Kleckner
Chicago, Illinois

James F. La Pond
Springfield, Massachusetts

Austin Lew
Oakland, California

Thomas A. Mahoney
New York, New York

Bobby T. Martin
Charlotte, North Carolina

L. Martin Miller
Charlotte, North Carolina

Thomas C. Parsons
Chicago, Illinois

David E. Peelek
Whittier, California

Donald Rappaport
Philadelphia, Pennsylvania

Thomas A. Ross, Jr.
Jackson, Mississippi

Sandra S. Schmidt
Boca Raton, Florida

Ernest Ten Eyck
Philadelphia, Pennsylvania

Thomas S. Watson, Jr.
Washington, D. C.

William T. Young
Madison, Wisconsin

EXHIBIT A

A Report on a Survey Conducted for the Government-business Forum

by
Jerry L. Arnold
Associate Professor and Director,
SEC and Financial Reporting Institute

University of Southern California

The Executive Committee of the Government-business Forum desired input from executives of smaller businesses in selecting the issues to be addressed at the Forum. In this regard, the SEC and Financial Reporting Institute of the University of Southern California sponsored a survey to determine the views of these business executives as to the most useful steps that could be undertaken to encourage capital formation. The study was conducted by Professor Jerry L. Arnold, the Institute Director.

The purposes of this report are to describe the research instrument and how it was developed, to explain how the sample was selected, and to present the survey findings.

RESEARCH INSTRUMENT

A survey questionnaire was utilized to determine the attitudes of smaller business executives concerning the relative usefulness of alternative steps that could be taken to assist capital formation. The broad categories and specific potential actions were as follows:

Income Taxation

Reduction in corporate tax rates

Relief of the double-taxation of corporate income

Further changes in the rate or other tax treatment of capital gains

Tax incentives for the purchase of specified securities issued by small businesses

Securing Credit From Banks

Reducing compensating balance and/or collateral requirements

Securing Credit From Banks (Continued)

Relaxing restrictive covenants on loan agreements

Reduction of interest rates

Lengthening of repayment periods

Access to Financial Institutions

Incentives to stockbroker/dealers to assist small businesses both in issuing securities and maintaining an after-market

Relaxing the ERISA restrictions to encourage investment in small businesses

Incentives to encourage local bank growth and development

Incentives to institutional investors to invest in small businesses

Raising Capital

Reducing corporate liability associated with issuance of securities

Reducing cost of complying with securities regulations

Reducing information requirements for present and prospective shareholders

Reducing complexities caused by different requirements of Federal/State authorities

These categories and potential actions were selected as a result of several meetings between Professor Arnold and members of the Executive Committee of the Government-business Forum.

The individuals participating in the study were asked to rank the possible steps, in each category, in the order in which they believed the actions would encourage capital formation. The most helpful step was to be ranked first and the least helpful fourth. In addition, space was provided in each category for the

participants to suggest other actions which might assist capital formation. (Review of the suggested "other actions" indicated no discernible pattern in any category. As a result, it seems appropriate to conclude that those responding to the questionnaire perceived the potential steps listed above to be reasonably complete.)[1]

The questionnaire also asked participants to indicate other factors which might improve their company's ability to raise or retain capital, the nature of problems (if any) encountered in obtaining capital, and selected demographic data about themselves and their companies. Further, executives from privately-held companies were asked why their companies had chosen not to "go public," the probability that they would "go public" within the next five years, and whether their companies were at an optimal size or needed to grow. A copy of the actual questionnaire is attached.

SAMPLE SELECTION

During the week of May 24, 1982, a total of one-thousand-four-hundred and eighty-nine (1,489) questionnaires were mailed to executives of smaller companies located primarily in the New York, Los Angeles, and Chicago areas. These individuals represent a diverse cross-section of companies and were drawn from lists furnished by various members of the Executive Committee as well as a list of privately held companies compiled from Dun & Bradstreet and Standard & Poor data. A total of two-hundred-seven (207) usable responses were received, representing a response rate of 14%. Selected demographic data concerning the respondents and their companies are presented in Table 1 below:

1/ Examples of the "other actions" proposed by participants include: a flat tax rate, various types of tax credits (e.g., for initial investment in a new venture, for research and development), regulations controlling costs charged by underwriters of small offerings, and a mandatory Government balanced budget.

Table 1
Selected Demographic Data
Number of Respondents = 207*

Position of the respondent:	Generally vice-president, treasurer or above	
Ownership structure of company:	28%	publicly-held
	72	privately-held
	100%	Total (n=201)
Number of employees:	7%	0-4
	3	5-9
	10	10-19
	27	20-49
	20	50-99
	33	100 and above
	100%	Total (n=204)
Annual sales volume:	6%	Less than 1 million
	40	$1 - $5 million
	17	$6 - $10 million
	12	$10 - $15 million
	12	$16 - $25 million
	13	Over $25 million
	100%	Total (n=200)
Industry:	2%	Retailing - franchise
	5	Retailing - other
	12	Manufacturing - high technology
	21	Manufacturing - other
	14	Service
	6	Construction
	2	Extractive
	14	Wholesale trade
	24	Other+
	100%	Total (n=207)

*Not all respondents answered each question and in some cases responses were unusable.

+Includes those checking multiple categories and those not answering the question as well as those indicating another industry.

RESULTS

This section presents and discusses the survey results. Aggregate and detailed rankings of potential actions to assist capital formation are first considered, followed by discussion of responses to open-ended questions concerned with securing and retaining capital. The responses to questions addressed to private company executives only are then addressed.

Results of Rankings

The rankings of responses by category were based upon the relative percent of number 1 ranks assigned to each potential step. That is, the step receiving the largest percent of number 1 ranks was ranked first and the one receiving the smallest percent was ranked fourth. The overall rankings are presented in Table 2. Some participants did not assign a rank to each step. As a result, the number actually ranking each step was less than two-hundred-seven (207) and ranged from a minimum of one-hundred-ninety-one (191) to a maximum of two-hundred-two (202).

Table I
Ranking of Possible Steps to Assist Capital Formation
Based upon Relative % of Number 1 Ranks Assigned By Category
Number of Respondents = 207*

Rank	Income Taxation	% Number 1 Ranks Assigned
1	Relief of the double-taxation of corporate income	37
2	Reduction in corporate tax rates	35
3	Tax incentives for the purchase of specified securities issued by small businesses	21
4	Further changes in the rate or other tax treatment of capital gains	7
	Total	100 %

Rank	Securing Credit From Banks	% Number 1 Ranks Assigned
1	Reduction of interest rates	93
2	Reducing compensating balance and/or collateral requirements	4
3	Lengthening of repayment periods	3
4	Relaxing restrictive covenants on loan agreements	0
	Total	100%

Rank	Access To Financial Institutions	% Number 1 Ranks Assigned
1.	Incentives to institutional investors to invest in small businesses	39
2.	Incentives to encourage local bank growth and development	24
3.	Relaxing the ERISA restrictions to encourage investment in small businesses	20
4	Incentives to stockbroker/dealers to assist small businesses both in issuing securities and maintaining an after-market	17
	Total	100 %

*As noted previously, less than 207 actually ranked each step.

Table 2 (continued)

Rank	Raising Capital	% Number 1 Ranks Assigned
1	Reducing complexities caused by different requirements of Federal/State authorities	45
• 2.	Reducing cost of complying with securities regulations	35
3	Reducing corporate liability associated with issuance of securities	11
4	Reducing information requirements for present and prospective :hareholders	9
	Total	100 %

The aggregate data in Table 2 were further broken down by: type of ownership (public vs. private), industry, and size of company. Not all participants answered each demographic question. Therefore, the responses assigned to the various classifications total less than two-hundred-seven (207).

Review of the data indicates that in each case there are a number of differences across the classifications in terms of percent of number 1 ranks assigned. For purposes of brevity, only selected differences are addressed.

Type of Ownership: Public vs Private. Participants were asked to indicate whether their companies are publicly-or privately-held. Of the two-hundred-one (201) answering this question, one-hundred-forty-four (144) or 72% represent privately-held companies and fifty-seven (57) or 28% are from publicly-held companies. The rankings, based upon type of ownership, are presented in Table 3. Analysis of the results indicates that executives from public companies viewed tax incentives for purchase of specified securities (31% number 1 ranks) and incentives to stockbroker/dealers (25% number 1 ranks) as relatively more beneficial to capital formation than did their counterparts from private companies (17% and 13% number 1 ranks, respectively). Further, although ranked number 1 by both groups, incentives to institutional investors to invest in small businesses attracted a substantially higher percent of number 1 ranks from public company executives (55%) than from private company executives (33%). In contrast, those from private companies placed considerably more emphasis on local bank growth and development and relaxation of ERISA restrictions than did those from public companies. These findings suggest that in general publicly-held companies are more inclined to seek avenues to expand their ownership base than are privately-held companies.

Table 3
Rankings of Possible Steps to Assist Capital Formation
Based Upon Relative % of Number 1 Ranks Assigned
Ownership Structure By Category

	Overall N=207 Rank	% No. 1	Public Companies N=57 Rank	% No. 1	Private Companies N=144 Rank	% No. 1
Income Taxation						
Relief of the double-taxation of corporate income	1	37	2	30	1	40
Reduction in corporate tax rates	2	35	2	30	2	37
Tax incentives for the purchase of specified securities issued by small businesses	3	21	1	31	3	17
Further changes in the rate or other tax treatment of capital gains	4	7 100%	4	9 100%	4	6 100%
Securing Credit From Banks						
Reduction of interest rates	1	93	1	87	1	95
Reducing compensating balance and/or collateral requirements	2	4	3	4	2	3
Lengthening of repayment periods	3	3	2	9	3	1
Relaxing restrictive covenants on loan agreements	4	0 100%	4	0 100%	3	1 100%
Access to Financial Institutions						
Incentives to institutional investors to invest in small businesses	1	39	1	55	1	33
Incentives to encourage local bank growth and development	2	24	3	13	2	29
Relaxing the ERISA restrictions to encourage investment in small businesses	3	20	4	7	3	25
Incentives to stockbroker/dealers to assist small businesses both in issuing securities and maintaining an after-market	4	17 100%	2	25 100%	4	13 100%
Raising Capital						
Reducing complexities caused by different requirements of Federal/State authorities	1	45	2	25	1	54
Reducing cost of complying with securities regulations	2	35	1	55	2	26
Reducing corporate liability associated with issuances of securities	3	11	4	7	3	13
Reducing information requirements for present and prospective shareholders	4	9 100%	3	13 100%	4	7 100%

Industry. The participants were presented with a list of industries and were asked to indicate the category that best describes the one in which their company operates. The rankings by industry are presented in Table 4.

Review of Table 4 indicates that executives from "high-tech" manufacturing companies placed relatively more emphasis on tax incentives for purchase of specified securities and incentives to stockbroker/dealers than did the group as a whole. Further, those from the extractive industry perceived incentives to stockbroker/dealers as most important in gaining access to financial institutions. These findings are not surprising in light of the presence and involvement of "high-tech" and extractive companies in the capital markets.

Size of Company. Two measures, sales and employees, were applied to classify companies into size categories. Table 5 presents the results by sales and Table 6 by employees. Among the more interesting findings is the apparent interest on the part of those from smaller companies in the use of tax incentives for the purchase of securities to attract outside capital. This item was ranked number 1 or 2 by executives from all categories of companies with less than $10 million in sales and/or less than fifty (50) employees, except for those in the $1 - $5 million of sales range. Further, representatives from the smallest companies (less than $1 million in sales) viewed incentives to stockbroker/dealers as very helpful in gaining access to financial institutions. Considered together, these results suggest that smaller companies are indeed interested in ways to increase the attractiveness and marketability of their securities.[2]

[2/] At first glance, it might seem inconsistent that small companies appear quite interested in attracting outside capital, while privately-held companies as a whole appear somewhat less interested. It should be noted, however, that the size and ownership structure of companies in the study are not directly related. Review of the individual questionnaires indicates that the study includes public companies which fall into the smallest size categories as well as private companies which belong in the largest.

Table 4
Rankings of Possible Steps to Assist Capital Formation
Based Upon Relative % of Number 1 Ranks Assigned
Industry By Category

	Overall N=207		Retailing N=15		Manufacturing H. Tech. N=25		Manufacturing Other N=44		Service N=29		Construction N=12		Extractive N=5		Wholesale Trade N=28	
	Rank	% No. 1	Rank	% No. 1	Rank	% No. 1	Rank	% No. 1	Rank	% No. 1	Rank	% No. 1	Rank	% No. 1	Rank	% No. 1
Income Taxation																
Relief of the double-taxation of corporate income	1	37	2	40	1	37	2	30	1	35	3	25	1	40	1	44
Reduction in corporate tax rates	2	35	1	47	3	25	1	57	3	21	2	33	3	20	2	33
Tax incentives for the purchase of specified securities issued by small businesses	3	21	3	13	2	34	3	7	2	34	1	42	4	0	3	19
Further changes in the rate or other tax treatment of capital gains	4	7	4	0	4	4	4	6	4	10	4	0	1	40	4	4
		100%		100%		100%		100%		100%		100%		100%		100%
Securing Credit From Banks																
Reduction of interest rates	1	93	1	93	1	92	1	93	1	93	1	92	1	100	1	96
Reducing compensating balance and/or collateral requirements	2	4	2	7	2	8	3	2	2	4	2	8	2	0	2	4
Lengthening of repayment periods	3	3	3	0	3	0	2	5	4	0	3	0	2	0	3	0
Relaxing restrictive covenants on loan agreements	4	0	3	0	3	0	4	0	3	3	3	0	2	0	3	0
		100%		100%		100%		100%		100%		100%		100%		100%
Access to Financial Institutions																
Incentives to institutional investors to invest in small businesses	1	39	1	40	1	44	1	32	1	52	4	8	2	40	3	26
Incentives to encourage local bank growth and development	2	24	1	40	4	9	2	30	2	28	1	42	3	0	2	30
Relaxing the ERISA restrictions to encourage investment in small businesses	3	20	3	13	3	17	3	23	4	4	2	33	3	0	1	33
Incentives to stockbroker/dealers to assist small businesses both in issuing securities and maintaining an after-market	4	17	4	7	2	30	4	15	3	16	3	17	1	60	4	11
		100%		100%		100%		100%		100%		100%		100%		100%
Raising Capital																
Reducing complexities caused by different requirements of Federal/State authorities	1	45	1	53	2	29	2	35	1	53	1	55	3	0	1	50
Reducing cost of complying with securities regulations	2	35	2	33	1	46	1	47	2	24	4	9	1	80	2	21
Reducing corporate liability associated with issuance of securities	3	11	3	14	4	8	3	14	3	12	2	18	2	20	4	8
Reducing information requirements for present and prospective shareholders	4	9	4	0	3	17	4	4	4	11	2	18	3	0	3	13
		100%		100%		100%		100%		100%		100%		100%		100%

Table 5
Rankings of Possible Steps to Assist Capital Formation
Based Upon Relative % of Number 1 Ranks Assigned
Annual Sales Volume By Category

	Overall N=207		Less Than $1 M. N=12		$1-5 M. N=80		$6-10 M. N=34		$10-15 M. N=24		$16-25 M. N=23		Over $25 M. N
	Rank	% No. 1	Rank	% No. 1	Rank	% No. 1	Rank	% No. 1	Rank	% No. 1	Rank	% No. 1	Rank	% No
Income Taxation														
Relief of the double-taxation of corporate income	1	37	2	25	1	41	3	23	1	43	2	36	1	44
Reduction in corporate tax rates	2	35	3	17	2	31	1	47	2	35	1	45	2	30
Tax incentives for the purchase of specified securities issued by small businesses	3	21	1	58	3	20	2	27	4	9	3	15	3	19
Further changes in the rate or other tax treatment of capital gains	4	7	4	0	4	8	4	3	3	13	4	4	4	7
		100%		100%		100%		100%		100%		100%		100
Securing Credit From Banks														
Reduction of interest rates	1	93	1	100	1	93	1	94	1	96	1	91	1	82
Reducing compensating balance and/or collateral requirements	2	4	2	0	2	4	2	6	3	0	2	5	3	7
Lengthening of repayment periods	3	3	2	0	3	3	3	0	3	0	3	4	2	11
Relaxing restrictive covenants on loan agreements	4	0	2	0	4	0	3	0	2	4	4	0	4	0
		100%		100%		100%		100%		100%		100%		100
Access to Financial Institutions														
Incentives to institutional investors to invest in small businesses	1	39	2	33	1	35	1	52	1	30	1	45	1	44
Incentives to encourage local bank growth and development	2	24	4	16	2	31	3	16	3	22	2	23	3	15
Relaxing the ERISA restrictions to encourage investment in small businesses	3	20	3	17	3	20	2	20	3	22	4	9	2	30
Incentives to stockbroker/dealers to assist small businesses both in issuing securities and maintaining an after-market	4	17	1	34	4	14	4	12	2	26	2	23	4	11
		100%		100%		100%		100%		100%		100%		100
Raising Capital														
Reducing complexities caused by different requirements of Federal/State authorities	1	48	1	50	1	47	1	50	1	46	2	27	1	41
Reducing cost of complying with securities regulations	2	39	2	33	2	30	2	31	2	36	1	50	2	37
Reducing corporate liability associated with issuance of securities	3	11	4	0	3	10	4	6	3	18	4	9	4	4
Reducing information requirements for present and prospective shareholders	4	9	3	9	4	5	3	13	4	0	3	14	3	10
		100%		100%		100%		100%		100%		100%		100

Table 6
Rankings of Possible Steps to Assist Capital Formation
Based Upon Relative # of Number 1 Ranks Assigned
Number of Employees By Category

	NUMBER OF EMPLOYEES									
	Overall N=207		Less Than 20 N=41		20 to 49 N=54		50 to 99 N=40		Over 99 N=69	
	Rank	% No. 1	Rank	% No. 1	Rank	% No. 1	Rank	% No. 1	Rank	% No. 1
Income Taxation										
Relief of the double-taxation of corporate income	1	37	1	32	1	44	2	26	1	40
Reduction in corporate tax rates	2	35	3	25	3	25	1	64	2	32
Tax incentives for the purchase of specified securities issued by small businesses	3	21	2	31	2	26	3	10	3	19
Further changes in the rate or other tax treatment of capital gains	4	7	4	12	4	5	4	0	4	9
		100%		100%		100%		100%		100%
Securing Credit From Banks										
Reduction of interest rates	1	93	1	95	1	90	1	100	1	88
Reducing compensating balance and/or collateral requirements	2	4	2	5	2	6	2	0	3	4
Lengthening of repayment periods	3	3	3	0	3	4	2	0	2	6
Relaxing restrictive covenants on loan agreements	4	0	3	0	4	0	2	0	4	2
		100%		100%		100%		100%		100%
Access to Financial Institutions										
Incentives to institutional investors to invest in small businesses	1	39	1	40	2	28	1	34	1	51
Incentives to encourage local bank growth and development	2	24	2	27	3	27	2	32	3	17
Relaxing the ERISA restrictions to encourage investment in small businesses	3	20	4	10	1	30	3	24	4	14
Incentives to stockbroker/dealers to assist small businesses both in issuing securities and maintaining an after-market	4	17	3	23	4	15	4	10	2	18
		100%		100%		100%		100%		100%
Raising Capital										
Reducing complexities caused by different requirements of Federal/State authorities	1	45	1	46	1	55	1	48	2	36
Reducing cost of complying with securities regulations	2	35	2	39	2	23	2	29	1	43
Reducing corporate liability associated with issuance of securities	3	11	4	7	3	11	3	21	4	9
Reducing information requirements for present and prospective shareholders	4	9	3	8	3	11	4	2	3	12
		100%		100%		100%		100%		100%

Raising and Retaining Capital

Participants were asked to discuss any problems they may have experienced in obtaining capital and to offer any suggestions of factors (not included in the rankings) which might improve their ability to raise or retain capital. In addition to high interest rates, which were cited by a number of participants, problems noted include:

- the amount of collateral and personal guarantees required by banks
- inability to attract brokerage firms to underwrite new issues
- high cost of issuing securities.

Participants did suggest a variety of actions which might enhance their ability to raise or retain capital. Among their ideas were:

- circularization of small business information
- incentives to banks to finance small businesses
- development of a mechanism for credit worthy small companies to issue commercial paper.

Other proposals were reflected in these actual comments from participants:

> Provide tax credits for hiring unemployed on unemployment insurance. Credits to be equal to benefits that would have been paid if unemployed beneficiary had not been given job.
>
> Relax Section 1244 of IRC to enable ordinary loss treatment for small emerging companies. Economic conditions and inflation have changed since enactment reducing use of this section.

Private Company Perspective

Executives from private companies were asked to indicate, on a 1 to 5 scale, their views as to whether their companies have achieved an optimal size as well as their assessment of the probability that their companies would "go public" within the next five years. Their responses are summarized below:

Company is at An Optimal Size and Does Not Need to Grow		Probability of Going Public	
1 Strongly Disagree	66%	1 Very Unlikely	79%
2	25	2	9
3 Agree	4	3 Reasonably Possible	7
4	2	4	2
5 Strongly Agree	3	5 Very Likely	3
Total	100%	Total	100%

Clearly, the companies represented in this study do wish to grow, but do not expect to "go public" in the near future.

The private company participants were also asked to comment on why their companies had chosen not to "go public." Review of their responses provides further insight into the nature of these companies. Major considerations for remaining private include the desire of the owner(s) to retain control and to have maximum flexibility in decision-making. Other reasons cited include:

- the perception of the owner(s) that the company is too small to go public
- the red tape involved in public ownership
- costs of going public
- lack of knowledge on how to go public
- preservation of confidentiality of operating results.

Selected actual comments from participants follow:

> I don't believe we're big enough to go public. Even if we were, I would hesitate because I feel I would be losing "control". And I like the absolute privacy. I would consider it if there was a tremendous opportunity at hand and capital was a major problem.
>
> We are a small company and are relatively unknown outside of our trading area. Being unknown we feel that there would not be a market for our stock in the open market.
>
> No need to go public. Most lenders and banks supply enough capital to maintain present $6,000,000 volume and expansion needs.

CONCLUSIONS

The participants in this study have provided valuable insights into potential actions which might assist smaller businesses in securing and retaining capital. Their responses indicate that actions are deemed desirable in all basic areas related to capital formation, ranging from income taxation to gaining access to financial institutions. With the exception of interest rate reduction, no one action dominated their attention in any category and, in contrast, they expressed the view that there are a variety of steps available to improve their ability to attract and retain capital.

SCHOOL OF ACCOUNTING
BRIDGE HALL 306
(213) 743-2426

GOVERNMENT - BUSINESS FORUM

ISSUES QUESTIONNAIRE

INTRODUCTION

The questionnaire is divided into three sections. The first section addresses possible steps that could be taken to assist capital formation. The second, applicable only if your company is privately-held, is concerned with reasons why you have chosen not to "go public" and your plans for the future. The final section focuses on demographic data concerning your company.

The questionnaire should take approximately 15 - 20 minutes to complete and all responses are anonymous. Thank you in advance for your cooperation.

Please return completed questionnaire in the enclosed postage-paid envelope to:

University of Southern California
Professor Jerry L. Arnold
School of Accounting
Bridge Hall 306
Los Angeles, California 90007

I. IDENTIFICATION OF STEPS TO ASSIST CAPITAL FORMATION

A. The purpose of this section is to determine the relative importance of certain steps that could be taken to improve the ability of your company to raise capital externally or generate it internally.

The possible actions are divided into four broad categories: income taxation, securing credit from banks, access to financial institutions, and raising capital.

For each separate category, please rank the listed items in the order in which you believe they would encourage capital formation.

In addition to ranking each listed item, please describe (but do not rank) any other items that might improve your company's ability to generate capital.

1) Income Taxation

Please rank the four possible actions listed below in the order in which you believe they would encourage capital formation. The most helpful action should be assigned a rank of 1 and the least helpful a 4. In addition, please describe (but do not rank) any other possible actions which could encourage capital formation.

	RANK
Reduction in corporate tax rates	____
Relief of the double-taxation of corporate income	____
Further changes in the rate or other tax treatment of capital gains	____
Tax incentives for the purchase of specified securities issued by small businesses	____
Other (please describe as specifically as possible, but do not rank):	

2) Securing Credit From Banks

Please rank the four possible actions listed below in the order in which you believe they would encourage capital formation. The most helpful action should be assigned a rank of 1 and the least helpful a 4. In addition, please describe (but do not rank) any other possible actions which could encourage capital formation.

	RANK
Reducing compensating balance and/or collateral requirements	____
Relaxing restrictive covenants on loan agreements	____
Reduction of interest rates	____
Lengthening of repayment periods	____
Other (please describe as specifically as possible, but do not rank):	

3) Access to Financial Institutions

Please rank the four possible actions listed below in the order in which you believe they would encourage capital formation. The most helpful action should be assigned a rank of 1 and the least helpful a 4. In addition, please describe (but do not rank) any other possible actions which could encourage capital formation.

	RANK
Incentives to stockbroker/dealers to assist small businesses both in issuing securities and maintaining an after-market	____
Relaxing the ERISA restrictions to encourage investment in small businesses	____
Incentives to encourage local bank growth and development	____
Incentives to institutional investors to invest in small businesses	____
Other (please describe as specifically as possible, but do not rank):	

4) Raising Capital
(e.g., issuance of stocks, bonds, etc.)

Please rank the four possible actions listed below in the order in which you believe they would encourage capital formation. The most helpful action should be assigned a rank of 1 and the least helpful a 4. In addition, please describe (but do not rank) any other possible actions which could encourage capital formation.

	RANK
Reducing corporate liability associated with issuance of securities	____
Reducing cost of complying with securities regulations	____
Reducing information requirements for present and prospective shareholders	____
Reducing complexities caused by different requirements of Federal/State authorities	____
Other (please describe as specifically as possible, but do not rank):	

B. In the space below, please describe any other factors which might improve your company's ability to raise or retain capital.

C. Has your company recently experienced any substantial problems in obtaining capital? If so, please describe the nature of the problem(s).

II. Please complete this section only if your company is privately-held (i.e., your stock is not traded on an exchange or over-the-counter). If your company is publicly-held, please go to Section III.

A. Briefly describe the reason(s) why your company has chosen to remain privately-held rather than "going public." Please be as specific as possible.

B. Please circle the number below which best describes the probability that your company will "go public" within the next five years.

Very Unlikely		Reasonably Possible		Very Likely
1	2	3	4	5

C. Please circle the number below which best describes your level of agreement with the following statement:

"My company is at an optimal size and does not need to grow."

Strongly Disagree		Agree		Strongly Agree
1	2	3	4	5

III. BACKGROUND DATA

Ownership structure:

_____ Publicly-held (traded on an exchange or over-the-counter)

_____ Private-held

Is your company a subsidiary of another company?

_____ YES _____ NO

Your position within the company_____

The following questions relate to the entity upon which your answers above were based:

Number of employees:

0 - 4	_____	20 - 49	_____
5 - 9	_____	50 - 99	_____
10 - 19	_____	100 and above	_____

Annual sales volume:

_____	Less than $1 million	_____	$10 - $15 million
_____	$1 - $ 5 million	_____	$16 - $25 million
_____	$6 - $10 million	_____	Over $25 million

Please check the category which best describes the industry in which your company operates:

_____ Retailing - franchise

_____ Retailing - other

_____ Manufacturing - high technology

_____ Manufacturing - other

_____ Service

_____ Construction

_____ Extractive

_____ Wholesale trade

_____ Other (please specify)

Exhibit B

SEC Government-Business Forum
on Small Business Capital Formation

Keynote Remarks

John S.R. Shad
SEC Chairman

September 23, 1982

This is an historic occasion - the first Government-Business Forum on Small Business Capital Formation.

The purpose of this Forum is to illuminate small business capital formation problems and evolve practical solutions.

Small businesses are of major importance to the national economy. They represent 97% of all U.S. firms and produce 43% of the Gross National Product. They account for three-quarters of all new jobs - at a time when the nation is grappling with 9.8% unemployment and a high level of bankruptcies.

Post-World War II Trends

Since the end of World War II, many of the nation's regulatory, fiscal and monetary policies have actually been antithetical to capital formation:

- o Mounting regulatory burdens;
- o Rising inflation, corporate and individual taxes;
- o Inadequate depreciation allowances;
- o Discriminatory taxation of interest and dividends;
- o As well as double taxation of dividends;
- o And one of the highest effective rates of capital gains taxation in the industrialized free world;

have been distinct disincentives to save and invest.

These policies have contributed to the significant decline in our relative rate of capital formation, among industrialized nations - from one of the highest to among the lowest. The inevitable consequence has been a similar decline in our relative growth in productivity.* For example, based on the average annual

---

* - 1973-81 average annual increase in productivity:
1) Japan 3.1%; 2) Germany 2.6%; 3)France 2.5%; 4) Belgium 2.2%;
5) Netherlands 1.5%; 6) Italy 1.5%; 7) UK 1.3%; 8) U.S. 0.2%;
9) Canada 0.1%.

14-658 O—83——15

increase in productivity from 1973 through 1981, we rank behind Japan, Germany, France, Belgium, the Netherlands, the United Kingdom and even Italy. Our 0.2% average annual increase in productivity compares with Japan's 3.1%. Japan's productivity is increasing at 15 times the rate in the U.S.!

If the United States is to maintain its leadership in this keenly competitive global community, these adverse trends must be reversed - now.

We have a great labor force in America, but the only way we can materially improve workers' standard of living is by increasing their productivity - and that takes capital. For example, capital for bigger and better machine tools that quadruple the operators' productivity - and thereby justify substantial wage increases.

The World's Best Capital Markets

The United States has by far the best capital markets the world has ever known - the broadest, the most active and efficient, and the fairest. The SEC's job is to help keep them that way. By effectively enforcing the antifraud, disclosure and oversight laws, the Commission facilitates the formation and the mobility of capital. It is notable in this regard that the only reference in the federal securities laws to capital formation is in connection with small business.

SEC Small Business Programs

In 1979 the Commission established the Office of Small Business Policy in the Division of Corporation Finance. Its task is to address the capital formation problems of small businesses posed by the securities laws. Toward this end, earlier this year the Commission expanded the applications of the S-18 short-form registration statement for securities offerings up to $5 million and adopted Regulation D, which exempts from registration certain offerings up to $5 million. Reg D also simplifies the exemptions for larger private placements. Most states are expected to enact comparable exemptions - which will be the first joint, state and federal registration exemptions. These initial steps are important precedent, in terms of future state and federal deregulatory initiatives for the benefit of small businesses.

Other Important SEC Programs

Other important programs at the SEC, include:

- The simplification and improvement of corporations' registration and reporting requirements, which telescope their time and expenses and afford them greater flexibility in scheduling and timing their financings;
- The placing of greater reliance on the private-sector self-regulatory organizations;
- The elimination of conflicts between regulatory authorities;
- And legislative initiatives which are intended to simplify and rationalize the regulatory structures of the financial service industries.

Conclusion

This distinguished forum will be addressing these and other issues of major importance to small businesses and the nation.

Thank you.

Exhibit C

TABLE I

CHANGES IN INDIVIDUAL INCOME TAX PROVISIONS AFFECTING U.S. CAPITAL GAINS

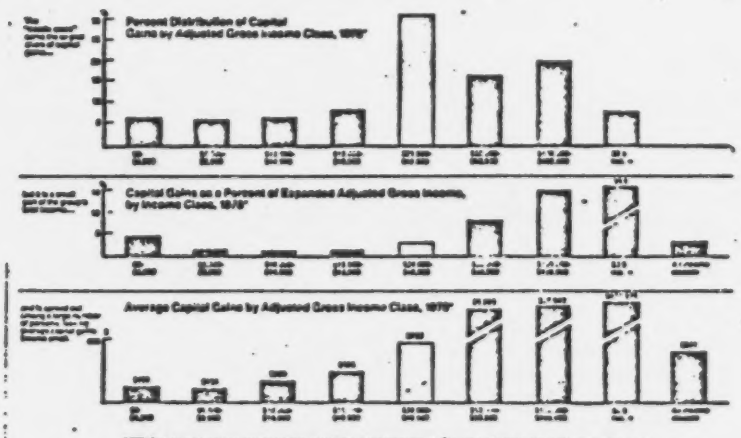
	Pre-1969	1969 Tax Reform Act	1976 Tax Reform Act	1978 Tax Revenue Act	1981 Economic Recovery Tax Act
Long Term Gains Subject to Capital Gains Tax	50%	50%	50%	40%	40%
Maximum Rate on Taxable Portion of Long-Term Gains	50%*	50%*	35%	35%	28%
Effective Maximum Rate on Long-Term Capital Gains, $50,000 or Less	25%	25%	25%	20%	20%
Tax on Preferential Income using approach to gains above $50,000	None	5%	7½%	7½% (Applicable only to certain minor add, but to the same class investment note received)	7½% (Applicable only to certain investments, but of the same class investment note received) 20%)
Effective Maximum Rate on Capital Gains above $50,000	25%	49.5%*	49%*	35%	28%
Holding Period	6 mos.	6 mos.	9 mos. in 1977, 1 year beginning 1978	1 year	1 year
Maximum Net Capital Loss Deductible Against Ordinary Income	$1,000	One-half of long-term loss up to a maximum of $1,000	One-half of long-term loss up to a maximum of $2,000 in 1977 and $3,000 thereafter	One-half of long-term loss up to a maximum of $3,000	One-half of long-term loss up to a maximum of $3,000

*Alternative tax, which generally has a 25% maximum rate on the excess of capital gains over net short-term capital loss. Under Pre-Act provisions this alternative rate of 25% was applied to 50% of the excess of net long-term capital gains over net short-term capital loss. Under the 1969 Act this was increased to 50% of the excess, so a 50% rate, furthermore was applied to 100% of such excess gains and losses.

**Including other preference rate issues.

SOURCE: New York Stock Exchange Office of Economic Research, *Federal Taxes in Historical Perspective* (New York: New York Stock Exchange, Inc., February 1982), p. 9.

WHO REALIZES CAPITAL GAINS


Percent Distribution of Capital Gains by Adjusted Gross Income Class, 1979*
Capital Gains as a Percent of Expanded Adjusted Gross Income, by Income Class, 1979*
Average Capital Gains by Adjusted Gross Income Class, 1979*

SOURCE: New York Stock Exchange Office of Economic Research, *Federal Taxes in Historical Perspective* (New York: New York Stock Exchange, Inc., February 1982), p. 10.

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Table 2

Common Stock Offerings For Which There Was No Prior Market (New Issues)

Year	No. of Issues	Share Value ($ Millions)
1968	649	1,742
1969	1,298	3,545
1970	566	1,451
1971	448	1,917
1972	646	3,301
1973	177	1,872
1974	55	117
1975	29	272
1976	45	271
1977	49	276
1978	58	214

Source: *Investment Dealers' Digest.*

TABLE 3

VENTURE CAPITAL INDUSTRY

ESTIMATED
FUNDINGS AND DISBURSEMENTS
(Millions of Dollars)

Year	New Private Capital Committed to Venture Capital Firms	Estimated Disbursements to Portfolio Companies	Public Underwritings of Companies with a Net Worth of $5 Million Or Less	
			Number	Amount
1981 (Est)	$1,300	$1,200	(306)	$1,760
1980	900	1,000	(135)	822
1979	319	1,000	(46)	183
1978	570	550	(21)	129
	Capital Gains Tax Decrease			
1977	39	400	(22)	75
1976	50	300	(29)	145
1975	10	250	(4)	18
1974	57	350	(9)	16
1973	58	450	(69)	180
1972	92	425	(409)	896
1971	95	410	(248)	551
1970	97	350	(196)	378
	Capital Gains Tax Increase			
1969	171	450	(696)	1,367

Total Capital Committed to the Organized Venture Capital Industry
Estimate at December 31, 1981

Independent Private Venture Capital Firms	$2.6 billion
Small Business Investment Companies	1.6 billion
Corporate Subsidiaries (Financial and Non-Financial)	1.6 billion
Total	$5.8 billion

This pool remained static from 1969 through 1977 at some $2.5-to-$3.0 billion (with new fundings more or less equal to withdrawals).

SOURCE. Venture Economics Division, Capital Publishing Corporation

"Venture Capital Industry Estimated Fundings and Disbursements" table reprinted courtesy of Venture Capital Journal, Capital Publishing Corporation, Wellesley Hills, Massachusetts.

TABLE 4

Total Capital Gains and the Effective Tax Rate on Capital Gains for Returns with Net Capital Gains Only (Individual Only) (1955-1979)

Year	Total gains*	Taxes paid on capital gain income	Effective tax rate
	(.....$ billions.....)		(Percent)
1955	$ 9.9	$ 1.2	12.0%
1956	9.7	1.1	11.8
1957	8.1	0.9	11.1
1958	9.4	1.1	11.1
1959	13.1	1.6	11.8
1960	11.7	1.4	11.6
1961	16.3	2.0	12.4
1962	13.5	1.6	11.8
1963	14.6	1.7	11.9
1964	17.4	2.2	12.7
1965	21.5	2.8	13.1
1966	21.3	2.7	12.8
1967	27.5	3.9	14.0
1968	35.6	5.2	14.5
1969	31.4	4.4	14.1
1970	20.8	3.0	14.6
1971	28.3	4.3	15.2
1972	35.9	5.6	15.7
1973	35.8	5.3	14.9
1974	30.2	4.3	14.3
1975	30.9	4.5	14.4
1976	39.0	6.2	15.9
1977	45.9	7.3	15.8
1978	51.5	8.3	16.1
1979**	72.1	10.1	14.0

*Net Long-term gain in excess of short-term loss plus short-term capital gain.
**Estimate.

Office of the Secretary of the Treasury
Office of Tax Analysis

March 20, 1981

TABLE 5

Distribution of Net Capital Gains Included in Adjusted Gross Income, by Adjusted Gross Income Class, 1978 and 1979

Adjusted gross income class ($000)	Net capital gain included in adjusted gross income			
	1978		1979	
	Amount ($ millions)	Percent (..%..)	Amount ($ millions)	Percent (..%..)
Under 2	$ 1,180	5.1	$ 1,068	4.0
	200	0.9	201	0.7
2 - 4	200	0.9	201	0.7
4 - 6	278	1.2	224	0.8
6 - 8	324	1.4	356	1.3
8 - 10	524	2.3	425	1.6
10 - 12	528	2.3	429	1.6
12 - 14	539	2.3	468	1.7
14 - 16	610	2.6	468	1.7
16 - 18	587	2.5	681	2.5
18 - 20	648	2.8	416	1.6
20 - 25	1,562	6.7	1,281	4.8
25 - 30	1,575	6.8	1,395	5.2
30 - 50	4,052	17.4	4,082	15.2
50 - 100	3,984	17.1	4,341	16.2
100 - 200	2,675	11.5	3,143	11.7
200 - 500	2,035	8.8	2,813	10.5
500 - 1000	858	3.7	1,587	5.9
1000 and over	1,076	4.6	3,426	12.8
Total	$23,231	100.0%	$26,803	100.0%

Office of the Secretary of the Treasury
Office of Tax Analysis

March 20, 1981

PROGRAM ON NEIGHBORHOOD
AND REGIONAL
CHANGE

MASSACHUSETTS INSTITUTE OF TECHNOLOGY, ROOM 9-322 CAMBRIDGE, MASSACHUSETTS 02139 (617) 253-6305

November 23, 1982

Congressman Henry Nowak
Chairman, Subcommittee on Tax, Access to
Equity Capital and Business Opportunities
B-363 Rayburn Building
Washington D.C. 20515

Dear Congressman Nowak:

In regards to your hearing on Wednesday, December 1st, regarding the SEC Forum recommendations on small business capital formation, I would like to submit for the record our recent report entitled "The Small Business Share of Job Creation: Lessons Learned from the Use of a Longitudinal File", a copy of which is enclosed.

Sincerely yours,

David L. Birch

DLB:slk

THE SMALL BUSINESS SHARE OF JOB CREATION: LESSONS LEARNED FROM THE USE OF A LONGITUDINAL FILE

by

David Birch

Susan MacCracken

November, 1982

MIT Program on Neighborhood

and Regional Change

The research forming the basis for this paper was conducted pursuant to Small Business Administration Contract No. SBA-5654-0A-81. The statements and conclusions contained herein are those of the contractor and do not necessarily reflect the views of the U.S. Government in general or the Small Business Administration in particular.

Abstract

Determining the small business share of employment growth is a difficult task using present data sources. The most common, and easily dealt with, mistake is to infer the performance of small businesses by comparing their aggregate share of jobs (or sales or GNP) at two different points in time. This is simply a logical error. As they grow and contract, firms change size categories from one period to the next, and it is impossible to infer their individual behavior from two different aggregate "snapshots" of the economy.

The only way to accurately measure small business performance is to follow individual small and large businesses over time. While easily understood in concept, this approach poses numerous problems in data collection and utilization. Most data which is available to researchers is collected in the private sector without the research user in mind. As a consequence, changes to the private files that make perfectly good sense from the viewpoint of the data collector wreak havoc with the use of those same data by researchers trying to study economic change.

The difficulties associated with using a private data source are well illustrated in a pair of related studies undertaken by ourselves and The Brookings Institution. Using the same data source, we discover that by taking careful account of changes made by Dun and Bradstreet to its so-called DMI file of individual business establishments, the percent of jobs created by smaller businesses in 1979 and 1980 is about 70 percent (see Table 8, p. 31). This is considerably higher than the 35 percent we obtain when necessary adjustments are not made.

This degree of variation raises a disturbing issue. Because Dun and Bradstreet does not document its file maintenance procedures carefully, we are frequently forced to estimate the effect of these procedures indirectly rather than directly. Efforts must be made, either to improve Dun and Bradstreet's documentation of maintenance changes, or to encourage the federal government to make better use of the data at its disposal, or both.

THE SMALL BUSINESS SHARE OF JOB CREATION: LESSONS LEARNED FROM THE USE OF A LONGITUDINAL FILE

As interest in the role of smaller businesses in our economy has grown in recent years, attempts to measure the small business contribution have become more numerous. Existing data collection systems are not well-suited to such measurements, however. The purpose of this paper is to outline some of the pitfalls that await the unwary analyst and policy maker -- the goal being to develop a more consistent basis for making comparisons over time and across different data sets.

The most common pitfall is to infer the behavior and performance of small business over time by comparing the small-business sector's shares of jobs or sales or GNP at different points in time. If the aggregate small-business share declines from one point to the next, it is assumed that individual small businesses are not doing well. The inference is not a valid one, because the same businesses are not being counted at each point. In fact, it is quite possible for individual small businesses to be flourishing at the same time that the small business share of employment declines. Table 1 illustrates this phenomenon in a small, hypothetical economy. The small businesses that grow are no longer small the second time around, and they are replaced by businesses substantially smaller than themselves. In this extreme example, none of the businesses classified as small (0-20) in the first period are in the same category in the second. The same phenomenon occurs, in less extreme form, in the actual economy.

Table 1

Individual Firms vs. Aggregate Statistics

in a Small, Hypothetical Economy

Individual Companies	1980 Employment	Changes 1980-1985 Startups	Expansions	1985 Employment
1	15		+10	25
2	15		+10	25
3	15		+10	25
4	15		+10	25
5	15		+10	25
6	15		+10	25
7	40		+10	50
8	40		+30	70
9	40		-10	30
10	40		- 5	35
11	-	5		5
12	-	5		5
13	-	5		5
14	-	5		5
15	-	5		5
Total	250	25	85	360

Summary Data

No. Firms 0-20	6			5
Employment in Firms 0-20	90			25
Jobs Created by Firms 0-20		25	60 Total =	85
Jobs Created by Firms over 20		-	25 Total =	25
% Jobs Created by Firms 0-20				77%

The only way to determine how well small (or any other kind of) business is doing is to follow individual companies over time from some known starting point. Following this approach, if a small business grows substantially between two points in time, the "credit" properly goes to the performance of small businesses. Similarly, if a larger business contracts into the small size category, this event reflects on the performance of larger corporations, and is not seen as growth in the small business sector.

The leap from articulating the need for a longitudinal file of individual businesses to building and using one properly is, of course, a big one. In the best of all worlds, the U.S. government would maintain such a file on a current basis and would perform the analysis for us. The government is moving slowly in this direction,[1] but, as revenues are withdrawn from the federal statistical system, the possibility of its being accomplished in the near future diminishes.

We are thus forced in the meantime to turn to private sources for the raw data. There are advantages to going this route. The data are in the public domain for the most part, and secrecy is not an issue. Furthermore, the private corporations who maintain records on individual companies have at least as great, if not a greater, motivation for keeping their information current and accurate -- its value in the marketplace is based on its currency and accuracy. In the worst case, the data provider can be sued if it distributes bad data. The information itself thus tends to be of as high a caliber as one might find in a federally maintained data set.

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[1] See Green, "Tracking Job Growth in Private Industry." (Monthly Labor Review; September, 1982) for a brief description of what different branches of government might do.

The problems that arise in using a private data source to construct corporate histories are due more to the purposes for which the private source goes about its business. Most private sources collect data to provide credit ratings, or marketing information, or both. In particular, they have no interest in measuring economic change over time in any aggregate way and do not pay particular attention to this potential use of their data as they go about collecting it. As a consequence, they do a number of things that are perfectly logical from their perspective but which make measurement of economic change difficult. For example:

1. They are in no hurry to add each newly formed firm to the file because there is little interest in such firms (particularly the smaller ones) from a credit reporting and marketing standpoint. It takes as long as seven or eight years for any particular group of new formations to be reasonably well covered in the file. New firm formations are thus greatly understated during the first years after they are formed.

2. Private data collectors are not nearly so interested in consistency over time as they are in having the current file be as useful as possible. As a consequence, they are continuously purging old records, not because a firm disappears, but because no one has asked about it recently or because it has moved to a new, unknown address. Similarly they expand coverage in selected areas to enhance the value of the file, but, in the case of branch operations, without indicating the actual age of the plant or office covered by the new record. It is thus impossible to distinguish the formation of a truly new establishment (a significant economic event) from a simple increase

in coverage of the existing corporate population (a significant enhancement of the value of the file for marketing purposes but not a change in the world itself).

The shorter the interval over which change is to be measured, and the more aggressive the data provider becomes in enhancing the file for marketing purposes, the greater the difficulty in separating file enhancement from actual change and hence the greater the peril in using the file as an economic tool.

Many of these problems are well illustrated in a pair of related projects being undertaken by ourselves and the Brookings Institution under Small Business Administration (SBA) sponsorship. Brookings received data from the Dun and Bradstreet corporation (one of the major private providers of data on individual establishments) for June of 1979 and December of 1980. Brookings did a substantial amount of cleanup work, particularly in the area of reconciling branch employment to total employment in multiunit firms, and constructed an initial longitudinal file covering the one and one half year period under study. In addition, they shipped us their individual files to put through our own editing and checking routines as part of a larger effort to develop a monitoring system.

Initial Brookings Findings

In its first tabulations,[1] the Brookings group investigated many aspects of employment creation. We will focus in this analysis only on the small business share of employment, since it illustrates the problems of using longitudinal files so well.

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[1] See Armington and Odle, Sources of Employment Growth 1978-1980 (The Brookings Institution; March, 1982).

Table 2 summarizes the Brookings findings, and compares them with our own findings for the 1969-1976 period. Initially, the Brookings group assumed the differences were attributable to the fact that we did our analysis by size of individual establishment rather than by the size of the overall corporation to which an establishment in a multiunit firm might belong. A small sales office of General Motors should not, it is argued, be treated as though it were an independent small business.

Table 2

Comparison of Brookings and MIT Estimates

of Small Business Share of Employment

% Jobs Created in Enterprises
with Fewer than 100 Employees:

Brookings (1979-1980)	MIT (1969-1976)
39%	82%

In fact, we made the same distinction between establishment and overall enterprise size that Brookings did. As we put it in The Job Generation Process[1]:

> We are still left with the question: What kind of establishments and firms are generating jobs within these broad status categories? Is it large or small firms that are taking up the slack, and in what industries?

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[1]See Birch, The Job Generation Process (Summary), (MIT, 1979, p.6-7).

> Before answering that question, we had to take a complicated and time-consuming step. The data we start with is recorded for each establishment -- each separate facility, be it a branch store or plant, a subsidiary, a headquarters, or an independent. Yet it is firms, not establishments, that are making job expansion decisions. So, before we can identify the economic scale at which jobs are being generated, we must first bundle all the members of each corporate family into a single entity called the firm, and then do our analyses for firms.

All of our analyses of net job creation by size reported in The Job Generation Process are based on size of enterprise, not size of establishment. How, then, do we explain the differences?

One explanation might be actual variations in the small business share of job creation. We found in our earlier work[1] that the small business share of employment does indeed seem to fluctuate a great deal from one period to another, and is sensitive to the business cycle. Interestingly, much of the fluctuation in this share is due to fluctuations in the performance of larger, rather than smaller, companies. The smaller ones, in aggregate, are more stable; their share depends to a great degree on how well larger firms are doing. In some parts of the country, where larger firms are declining in aggregate, the small-firm share can actually exceed 100 percent.

But it seems unlikely to us that the fluctuations would be as great as those suggested in Table 2. The 1979-1980 period was not that radically different from corresponding periods in the early and mid 1970's.

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[1] See Birch and MacCracken, Corporate Evolution: A Micro-Based Analysis, (MIT Program on Neighborhood and Regional Change, 1981).

We begin to get a better understanding of where the differences lie when we look at the details beneath the summary data provided by Brookings. The Brookings group had, as one of its goals, the creation of a more or less complete census of the business population to compare against similar data sets provided by the government. Since the D&B file offers only a sample, Brookings decided to fill in the gaps, either by estimating one or more pieces of data where they were missing for a particular establishment, or by manufacturing entire hypothetical records to make up large differences. Brookings has been using an augmented file in its recent analyses of job creation, basing its findings on a 1979 employment total of 86 million jobs.[1] A closer look at the file reveals the following composition:

Table 3

Sources of Data in the Brookings File

	Employment (in 000's) in:	
	1979	1980
Establishment Data Directly from D&B	56,186	70,656
Employment in Records Modified by Brookings	11,014	2,567
Employment in Records Manufactured by Brookings	18,261	20,067
Total:	85,461	93,290

Source: U.S. Establishment and Enterprise Micro Data Base, as of June, 1982

Several things about these numbers are worth noting. First, the total number of jobs in the file substantially exceeds the total size of the U.S. workforce. The Brookings file covers only the private sector. When

[1]See Armington and Odle, "Sources of Job Growth--A New Look at the Small Business Role" (Commentary; Fall, 1982). In the analysis, Brookings has chosen not to use its imputed records directly, but instead to achieve the same effect by weighting all other records in the file by a factor to "puff them up" to the augmented total.

adjustments are made to achieve comparability between sources, the Brookings file contains 20.2 million more jobs in the U.S. than the Bureau of Labor Statistics can identify workers in the U.S.[1] As Brookings points out,[2] the BLS figures have been benchmarked against the decennial censuses and have been found to cover about 98 percent of the employees in the private, non-agriculture economy. So there exists a substantial discrepancy between what the government (in its censuses and employment insurance reporting) can identify and what the Brookings file portrays. Either the entire federal statistical system is totally off the mark (by 30 percent) or there is something odd about the process by which Brookings is adjusting and manufacturing data, or both. While the federal statistical system may have some problems in undercounting, the discrepancy also suggests that we should take a close look at the Brookings adjustment and imputation procedures.

There is another aspect of the figures in Table 3 that leads to the same conclusion. The employment growth implicit in the table is 7.8 million jobs between the middle of 1979 and 1980. Of this, Brookings clearly identifies 1.5 million as simply additions to the file that do not represent any economic change, leaving a "true" change of 6.3 million. BLS, in contrast, shows a private-sector employment change between 1978 and 1980 of 3.3 million. Assuming 75 percent of the BLS change occurred between the middle of 1979 and the end of 1980, we have a growth of only 2.5 million jobs, or roughly 40% of the growth indicated in the Brookings file. Some of this difference could be due to lags in D&B's reporting, but not that much, since D&B claims to check

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[1] See Candee S. Harris, "A Comparison of Employment Data for Several Business Data Sources: County Business Patterns, Unemployment Insurance, and the Brookings' U.S. Establishment and Enterprise Microdata File" (The Brookings Institution, 1981).

[2] Ibid, p. 2.

on each of its larger companies every three months or every six months. We must thus examine the Brookings data generation procedures carefully.

Whenever Brookings discovered a missing employment figure for an establishment, they made one up based on averages by industry and state. Thus, if the industry average in a particular state was 8 employees, any firm in that industry and state missing an employment estimate in, say, 1979 was assigned a value of 8 (regardless, apparently, of its employment in 1980). Thus, if D&B reported no employment for an establishment in 1979 and 500 employees in 1980, the establishment would be assigned a 1979 employment of 8 and an employment growth of 492 employees. About 1.2 million jobs were estimated in this way in 1979 and 1.6 million in 1980.

In addition, the Brookings group noticed a significant discrepancy between the sum of all the employees reported in the individual establishments belonging to multiunit corporations and the total employment reported for those corporations as a whole. They chose to assume that the total figure was correct, and manufactured hypothetical branches containing the difference. As Table 3 indicates, they manufactured 18.2 million branch establishment jobs in 1979 and 20.1 million such jobs in 1980 following this approach.

At first blush, in view of the surplus of about 20 million jobs in the Brookings file, it would seem reasonable to at least question whether or not the total figures were as solid as the establishment employment figures from which they differ. The total figures, for example, might include overseas as well as domestic employment (although they are not supposed to) or total employment figures may simply not be as easily ascertainable as plant by plant and office by office employment counts might be.

Our investigation of the total employment figures provides some reasons for concern. We discovered, for example, that the total employment figure for every Brookings record we spot-checked by hand contained overseas as well as domestic employment. This included total employment figures for Exxon, General Telephone, RCA, United Technologies, Chrysler, IBM, General Motors, Boeing, and R.J. Reynolds. In many cases, large corporations of this kind are expanding overseas as they contract domestically. The Wall Street Journal[1] has documented through interviews, for example, that RCA cut its domestic employment by 14,000 during the 1970's and added 19,000 foreign workers. Similarly, GE showed a total expansion of 5,000 employees during the 1970's which it achieved by shrinking its U.S. labor force by 25,000 and expanding overseas by 30,000. The 29,000 net new RCA jobs created in the Brookings file between 1979 and 1980 are almost surely located overseas, as are a good portion of the 290,000 other expansion jobs recorded for this handful of firms checked.

In addition, there are two records in the file (a men's clothing store in California and the operator of a limestone cave in Missouri) that, in combination, had an expansion in total employment of 852,000 jobs. Assuming it followed its standard imputation procedures, Brookings would have imputed branches totaling about 852,000 net new employees between 1979 and 1980 for these two enterprises, amounting to almost half of all the gain in imputed employment in the 400,000+ records for which imputations were made.

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[1] Frederick Klein, "Manageable Size: Some Firms Fight Ills of Bigness by Keeping Employee Units Small." (Wall Street Journal; February 5, 1982).

Phone calls revealed the obvious: the records were in error, and the gains, if any, were modest -- at most 5 or 8 employees.

The inclusion of overseas employment of major corporations and of records like the men's clothing store and the limestone cave go a good way toward explaining why the Brookings file, in its raw form, contains 20 million more jobs than the Bureau of Labor Statistics records workers, and why employment growth in this raw file is so high. It also gives us reason to not base our analysis on the total employment figures, and to feel very uncomfortable about a complex weighting scheme that produces consistency with these totals. The scheme has the potential, not only to reflect a distorted total, but to distort the size distribution of employment change as well.

We are thus compelled (by choice and of necessity) to limit our analysis to those records and jobs for which most of the data were provided by Dun and Bradstreet. We are still left with the fact that, of the 67.2 million jobs remaining in 1979, Brookings modified 11.0 million (either to fill in missing data or to reconcile total with establishment employment) whereas they modified only 2.6 million (out of 73.2 million) in 1980.[1] There is thus the real possibility that the Brookings procedures affected one year more than another and introduced a bias due to the procedures and not the world. If we eliminate all manipulated records, however, we so deplete and distort the file that further analysis becomes meaningless. We decided instead, therefore, to pass all records (including the manipulated ones) through our own

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[1] It is worth noting that, even after imputed records are dropped, the Brookings file covers 95 percent of the 1978 employment reported by BLS and 99 percent of the BLS 1980 estimate -- high by historical D&B coverage standards which have ranged in the 80 to 90 percent range.

editing procedures and to purge only those that failed our tests of reasonableness.

The editing rules are described in detail elsewhere.[1] Basically they flag (and drop) records that, based on extensive field checks over the years, have a high probability of containing an error. We detect errors by looking carefully at change over time, and identifying changes that seem unrealistic. Our experience in field checking these procedures suggests that, for every 20 records we reject, 19 are actually bad and one is, in fact, correct. Since the D&B file is only a sample, we are happy to lose the one good record to get rid of 19 outrageous ones. In general, our procedures purge between two and three percent of the file, as they did in our work with the Brookings data.

Table 4 summarizes the magnitude and effect of the dropped records. As the table shows, most of the Brookings modified records passed our reasonableness test. However, these same records are three times more likely to fail than are the unaltered records. The effect among altered records is much greater in the 1979 file, where so much alteration took place, than it is in the 1980 file which was altered only slightly. The effect of the dropped records on net employment change is negligible (the big gainers canceling out the big losers) for both large and small enterprises. We drop a small net expansion among smaller enterprises and drop a small net contraction among larger ones, the overall effect amounting to a mere 142,000 jobs out of a total change of about 6 million, or about 2.4 percent. Our working assumption is that, once the dropped records have been removed from the file, most biases introduced by D&B recording errors and by Brookings alteration procedures have been eliminated.

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[1] See Allaman, "Using the Dun and Bradstreet Data for Research on Regional Economic Development." (Joint Center for Urban Studies, 1975). These rules have been modified slightly since 1975, but are essentially the same.

Table 4

Employment Dropped By Longitudinal Editing

(Employment in 000's)

A. Aggregate Effect of Dropped Records

Year	Data Source	Starting Empl.	Empl. in Dropped Records	% Empl. Dropped	Empl. Remaining After Drops
			1979		
1979	Direct from D&B	56,186	1,101	2.0%	55,085
	Brookings Modified	11,014	736	6.7%	10,278
	Total	67,200	1,837	2.7%	65,363
			1980		
1980	Direct from D&B	70,656	1,945	2.8%	68,711
	Brookings Modified	2,567	35	1.4%	2,532
	Total	73,223	1,980	2.7%	71,243

B. Effect of Drops on Change: 1979-1980

Enterprise Empl.	Net Change in Drops
0-99	+310
100+	-168
Total	142

Small Business Job Creation

Using this reduced and cleaned data set, we can now begin to explore the contribution of smaller businesses to job creation. We began by simply analyzing the components of change in aggregate in order to reconcile our results with those obtained by Brookings. Table 5 summarizes the analysis, and confirms that we are both talking about the same overall change of 6,307,000 jobs.[1]

In Table 5 we distinguish between three kinds of births:

Regular:	An establishment started up in 1979 or 1980 whose startup date is known from its reported age
Known New Listings:	An establishment started up some time during the five year period before 1979, whose startup date is known from its reported age
Branch New Listings:	A new branch was discovered in the file in 1980 that was not there in 1979. Since no age is listed in the file for branches, Brookings assumed it was a birth.

We note immediately that all the positive net change in the file is due to births that are, by definition, not births (known new listings), or births whose origins are uncertain (branch new listings). These problems are inherent in the way D&B constructs its files, as was mentioned earlier. In addition, there are some problems in the death column that, again, flow from D&B file editing procedures, and that we will get into shortly.

The effects of these file uncertainties are magnified when we look at their size distribution and their effects on different kinds of businesses. In Table 6 we have grouped all establishments whose age we know (independents, headquarters, and subsidiaries) into one category (Head Office) and have placed branches, whose age we do not know, into another. After eliminating all the manufactured records

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[1] We know also from detailed tabulation of the 1979 and 1980 Brookings files by state, size, and industry that we have exactly the same raw files described in their file documentation.

Table 5

Aggregate Components of Employment Change

(All figures in '000s)

Source	Component: Births	Deaths	Expansions	Contractions	Net Change
"Regular"	1,458	4,571	5,336	2,994	-771
Known New Listings	1,155	-	-	-	+1,155
Branch New Listings	3,974	-	-	-	+3,974
Reduced Total	6,587	4,571	5,336	2,994	4,358
Dropped Records	20	236	1,748	1,390	142
Brookings Weighting Procedures[1]	?	?	?	?	1,807
Total					6,307

1. Since we did not employ a weighting scheme, we did not compute the components of job change attributable to weighting. We do, however, know its net effect.

Table 6

Components of Employment Change by

Enterprise Size and Type in Reduced Brookings File

(All figures in '000s)

Enterprise Type	Reg. Birth	New List. Births	Death	Expan.	Contr.	Net Change
Small						
Head Office	1,152	930	2,032	2,517	1,234	1,333
Branch	-	329	202	87	23	191
Sm. Total	1,152	1,259	2,234	2,604	1,257	1,524
Large						
Head Office	306	225	938	1,547	1,096	44
Branch	-	3,645	1,399	1,185	641	2,790
Lg. Total	306	3,870	2,337	2,732	1,737	2,834
Grand Total	1,458	5,129	4,571	5,336	2,994	4,358
Sm. Bus. Share	79%	25%	49%	49%	42%	35%

and the suspicious altered ones, we still come up, in this initial tabulation, with a small-business share of job creation of 35 percent, which is quite close to the 37 percent estimated more recently by Brookings,[1] and which suggests that the Brookings weighting scheme had little affect on the ultimate outcome. We note, however, that the result hinges entirely on births that are not births--i.e., new listings. If new listings are removed from the analysis, the large business share of net new jobs actually goes negative. Since new listings are a phenomenon associated with D&B file maintenance procedures, we must examine carefully what a "Birth" really is. In addition, it turns out that we must, for many of the same reasons, look carefully at deaths. We will take them up in that sequence, examining first the problems of accurately measuring "real" births, and then turning to the various sources of spurious births and deaths attributable to file enhancement.

Regular Births

As mentioned earlier, one of the difficulties of working with a private data source is the provider's lack of concern for recording each new firm formation as it occurs -- particularly for smaller firms. For any actual group of 100 new firms started in a particular year, as few as 15 or 20 will show up in the DMI[2] file in that year. As time goes on, more and more are "discovered" by D&B. At the same time, more and more of the original 100 are dying. After seven or eight years, D&B "catches up" with this group and more or less tracks their behavior accurately. Figure 1 illustrates this general phenomenon.

There are great variations in this catch up process by industry, however. D&B tends to absorb manufacturing firms far more quickly than service

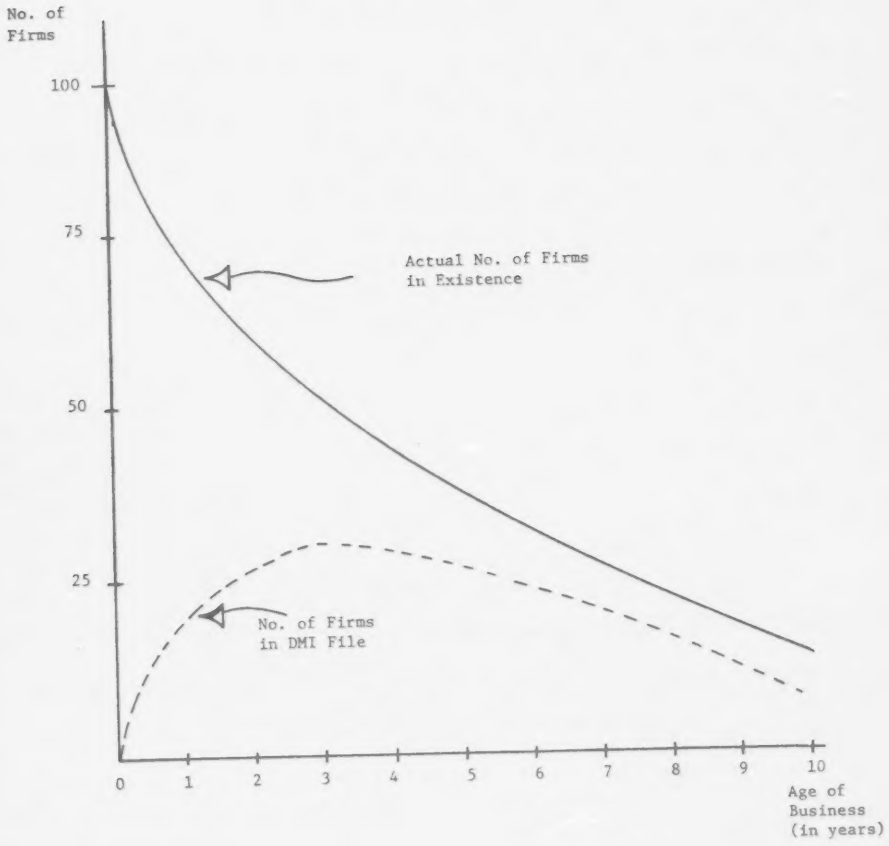
[1] See Armington and Odle, "Sources of Job Growth - A New Look at the Small Business Role" (Commentary; Fall, 1982).

[2] DMI stands for Duns Market Identifiers. The DMI file is the version of the D&B file provided to both Brookings and ourselves by Duns Marketing Services.

Figure 1

Actual Firm Population vs. D&B's

Measurement of that Population



firms, for example. Using data that now span 11 years (1969-1980), we have been able to trace the absorption into the file of all firms that were started in 1969, by industry. Knowing the death rates by industry and D&B's average coverage of establishments and employment in each industry, we have been able to calculate the amount by which actual firm births should be mutiplied to obtain an estimate of actual births in the "real world." It turns out that the magnitude of the adjustment is quite sensitive to the interval over which births are measured. The shorter the interval, the greater the percentage of the actual births that have not yet been discovered, and the greater the adjustment required. Table 7 summarizes the adjustments needed for different industries and time intervals.

The Brookings group was aware of the low absorption rate problem. In the absence of any data beyond the one and one half year interval at their disposal, however, they chose to compensate, not by adjusting for D&B reported births in the interval, but by accepting as a birth any non-branch firm entering the file for the first time that was 5 years old or younger. Unfortunately, this approach introduces two significant biases. First, it counts as births firms that were known to have started well before the interval under study. Thus firms starting in 1974, 1975, 1976, 1977, or 1978 are counted as births by Brookings in the 1979-1980 period. Since birth ates vary a great deal from year to year, there is no clear relationship between birth rates during the one and one half years under study and births that occurred over the previous 5 years.

Second, there is a "growth bias" introduced by allowing a 5 year interval

Table 7

Adjustment Required to D&B
Birth Data to Estimate
Actual Births

Industry	Factor by which to Multiply D&B Births to Estimate Actual Births when the Interval (in years) over which Births are measured is: 1	2	3	4	5
Agriculture	6.4	4.4	3.4	2.8	2.4
Manufacturing	2.1	1.9	1.8	1.7	1.6
Other Industry	2.6	2.3	2.0	1.8	1.7
Trade	1.8	1.7	1.6	1.5	1.5
Service	7.0	4.9	3.9	3.2	2.8

between a known birth and its first introduction into the file. In his analysis of the California Unemployment Insurance data, Michael Tietz[1] discovered that most of the jobs created by small businesses are created by a relatively small proportion of them (12-15%) that grow rapidly during their first 4 or 5 years. The odds are quite high, therefore, that a business that is small when it starts and that grows rapidly and creates a large number of new jobs in its youth, will have grown well beyond 20 or 100 employees by the time it is 5 years old, and will be classified, at that point, as the birth of a large business.

To test this proposition, and to confirm Tietz's finding, we traced the history in our own 7-year longitudinal file of all firms with a known startup date of 1972 at the end of 1972, at the end of 1974 (a 2-year lag) and at the end of 1976 (a 4-year lag). We found that the percentage of jobs that would have been attributed to large companies increased by 55 percent when those same companies were examined 4 years after they were formed instead of during the year in which they were formed.

We cannot, then, with any confidence "simulate" births simply by taking any firm started 5 years prior to the interval under study, as Brookings did. We must, instead, measure actual births that occurred (by size -- to capture the true size of the start-up firm) and adjust for the known low D&B absorption rates. Breaking the Brookings "Regular Births" into the five industry categories described in Table 7, and applying the average of 1-year and 2-year absorption factors (to account for the one and one half year interval in the Brookings file) we get a revised set of "real" birth estimates for Head Offices

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[1] Michael B. Tietz. "Small Business and Employment Growth in California." (Institute of Urban and Regional Development, University of California, Berkeley, 1981).

(including independents) of:

Small	3,327
Large	948
Total	4,275

These totals should replace the sum of "Regular Births" and "New Listing Births" for Head Offices, yielding the following correction to Table 6:

Small	Reg. Birth	New List. Birth	Death	Expan.	Contr.
Head Office	+2,175	-930			
Large					
Head Office	+ 642	-225			

File Enhancement

D&B is constantly improving the coverage and the currentness and accuracy of its file. As analysts of economic change we find ourselves in the following somewhat paradoxical position: the more D&B does to improve its file, the worse off we are. The problem, of course, is that file enhancements usually mean adding or subtracting records from the file that do not correspond to firms actually coming and going. Such enhancements often produce spurious births or deaths (sometimes of large magnitudes) that can be very difficult to detect and compensate for.

Spurious Births

Many potential spurious births due to file enhancement occur when D&B adds

a new record to the file for a compnay that was started some time ago, but which D&B has just "discovered." This phenonmenon of delayed absorption into the file was discussed earlier. D&B understandably does this, of course, to improve its coverage.

Fortunately, D&B also lists the date at which the establishment was started for most records. Both Brookings and ourselves capitalize upon this additional piece of information to distinguish between a true birth (one whose year-started falls within the interval for which births are being measured) and a spurious birth (or new listing, as we call them) that was started earlier and simply represents an addition to coverage.

The difficulty arises with branches. D&B does not inquire about the year in which a branch office or plant was set up, since the branch is really part of the headquarters to which it belongs for administrative, credit and legal purposes. It is effectively as old as its parent regardless of when it was actually established.

In the early 1970's D&B made no special efforts to isolate branches from their parents -- some branches it identified and some it did not. Our estimate is that about 50 percent of the branches were in the file and 50 percent were not, the omissions being mainly the smaller branches -- the sales offices or small distribution facilities of larger firms.

As the decade wore on, D&B realized that, from a marketing standpoint, branches were important, and that having them in the file as separate entities was important. It thus took several steps to enhance its branch coverage. For one thing, it clamped down hard on the rule that no reporter could send in a headquarter

report without identifying branches or a branch report without identifying its headquarters. It also began systematically searching for the branch locations of the larger corporations and adding them into the file.

A classic example of the effects of this enhancement activity showed up as early as 1976 in our file in Dayton, Ohio. Originally, D&B reported some (but not all) of General Motors' branches through one central location on 300 Taylor Street. Between 1972 and 1976 they decided to unbundle the branches thus covered and to add in the remaining ones. The net effect of these enhancements to the file was to generate a spurious employment growth of 4,775 GM jobs in Dayton between 1972 and 1976 that consisted of 7,775 branch-new-listing jobs offsetting an actual decline of 3,000 jobs due to layoffs. The effect of these changes were so large that they distorted the entire employment picture in Dayton -- which is how we discovered them. It took several phone calls to the GM personnel office in Dayton to unscramble what really occurred. Our own results for the 1969 to 1976 period reflect this kind of activity. Because D&B's initial efforts to increase its branch coverage were relatively modest, however, the effect was modest. We show a total employment growth between 1969 and 1976 of 6.7 million jobs compared to a comparable growth reported by BLS of 6.3 million. Since we carefully eliminated all new listings whose age was known (and had a seven-year interval over which to do it), the extra .4 million was undoubtedly due primarily to spurious branch births similar to the ones uncovered in Dayton. To the extent that they were included, they tend to overstate the large-business share of net employment change, since most branch new listings are associated with larger enterprises (see Table 6).

The Brookings file was much more heavily affected by D&B's increased branch coverage program, which culminated in the last quarter of 1980, when D&B added 10,000 existing Fortune 500 branches to the file, all of which were treated as branch births by Brookings. Fortunately (from the viewpoint of this analysis) D&B did not include the employment located at these branches in its files, so the additions affect the establishment count but not the employment totals. All other branch additions, however, do affect employment totals, as is obvious in Table 6. The problem becomes even more serious when changes in multiunit employment are examined by economic sector. Over 35 percent (1.1 million net new jobs) of all growth in multiunit enterprises in the Brookings file occurred in manufacturing (where D&B makes a special effort to add existing branches) during a period in which manufacturing employment declined in absolute terms nationwide by 200,000 jobs. Clearly a substantial number of the Brookings branch births are simply new listings, particularly in manufacturing. The question is: how many?

To estimate what percent of the Brookings branch new listings are real (and what percent are spurious), we compared employment growth in multiunit enterprises reported by the Census Bureau in its Enterprise Statistics with the corresponding growth in the Brookings file. Since not all sectors are covered in the Enterprise Statistics,[1] we must compare it with only a subset of the Brookings file. In the sectors covered, the Enterprise Statistics showed a compound annual growth rate in multiunit employment of about 2.8 percent between 1967 and 1977. The Brookings file, in contrast, when branch new listings

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[1] Covered sectors include Mining, Construction, Manufacturing, Wholesaling, Retailing and Selected Services. The 1977 figures in these sectors in the Enterprise Statistics cover 29 million employees in multiunit enterprises; the reduced Brookings file covers 30 million in 1979 in the same sectors.

are included, shows a compound growth rate in multiunit enterprise employment of 6.1 percent -- nearly 2.2 times the historical rate in the 10 years preceeding the period covered by the file.

Assuming the historical growth in multiunit enterprise employment in the early and middle 1970's holds in the late 1970's,[1] and applying that growth to the total 1979 Brookings employment base for such enterprises, we would expect an overall multiunit net expansion of 1,493,344 jobs between the middle of 1979 and the end of 1980. We know from the detailed tabulations summarized in Table 6 and our birth calculations that 583,766 of this overall multiunit employment growth was due to multiunit head offices (whose ages are known). This leaves a residual of 909,578 that we can attribute to the actual net change of branches. We also know (see Table 6) the expansions, contractions, and deaths of existing branches. We thus have:

Same	Employment Change
Unknown Branch Births	?
Known Branch Deaths	1,601
Known Branch Expansions	1,273
Known Branch Contractions	665
Estimated Net (from above)	910

and can calculate estimated real employment change due to branch births of 1,903,000, or about half of the total new-listing jobs. Assuming spurious branch births are distributed evenly over small and large enterprises, we can thus make the following correction to Table 6:

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[1] This is a rather generous assumption considering the fact that the Fortune 1000, which account for half of all multiunit employment in the Brookings file, shrank by 400,000 jobs during 1980.

Enterprise Type	Reg. Birth	New List. Birth	Death	Expan.	Contr.
Small Branch		-172			
Large Branch		-1,899			

Spurious Deaths

Spurious deaths usually arise because D&B decides to purge older (or otherwise not useful) records from its file. It tends to perform these purges in fairly large, one-shot operations. For example, between 1976 and 1978 D&B purged approximately 800,000 records that had not been accessed or updated for over 5 years -- most of them smaller firms. It was not assumed that the firms had died. They were removed in one large lump simply because they were cluttering up the file and ran the risk of providing out-of-date data to potential marketing customers. Assuming an average employment of, say, 8 employees, to the unwary analyst this would appear as a net loss of jobs (mostly in small business) of 6.4 million. This figure is approximately the same as all employment change taking place in the U.S. economy during the same period and would thus reduce apparent employment growth in that period to zero. Since there is no way to separate spurious from actual deaths -- both are detected as the absence of a record at the end of an interval that was present at the beginning -- the DMI file is virtually unusable as an instrument for measuring economic change during the 1976-1978 period. In particular, since most of the firms purged were small, using the file during the 1976-78 period would make it appear that small businesses were doing very poorly indeed.

The 1979-1980 interval studied by Brookings suffers from a similar problem. During this period, Duns Marketing Services (the provider of the DMI file used by Brookings) decided to purge all companies that did not respond to first-class mailings. These "Nixies," as they are called, arise primarily because a company moves and the D&B reporters have not yet caught up with it. Again, according to Dun and Bradstreet practically all of them are small, because D&B makes a much greater effort to track accurately those firms over 100.

The Nixie Purge was initiated by DMI clients who were frustrated by the costs associated with mailing out material to potential customers and having it returned. Many DMI clients use the data for mailing list purposes. Our own data on intra-city moves suggests that this could easily be a problem. About 10 to 12 percent of the employment change taking place within a city is caused by short-distance moves[1], and it is not surprising that the D&B reporter force cannot keep up with it -- particularly on the small end of the scale. Realizing that most of these companies still existed (but at some unknown address) the main D&B credit file retained them; it was only from the DMI file that they were removed.[2]

A total of 250,000 nixies were removed from the DMI file in the 1980-81 period, beginning in the first quarter of 1980. By D&B estimates, approximately 180,000 of these were removed in 1980, and virtually all of them were small. Assuming that the nixies were smaller than the average size (8) of all firms under 100 -- let's say they have 5 employees each -- this amounts to a

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[1] See Birch, Job Creation in Cities, (MIT Program on Neighborhood and Regional Change, 1980).

[2] Some of the removed companies probably had, in fact, gone out of business. It is very unlikely, however, that most of them died during the relatively short interval during which the purge was conducted.

spurious employment loss due to deaths of approximately 900,000 jobs. Assuming further that the nixies were distributed in proportion to the existence of addresses (i.e. in proportion to the existence of establishments) and that some, in fact, were in large as well as small establishments, we must make the following adjustment to Table 6:

Enterprise Type	Reg. Birth	New List. Birth	Death	Expan.	Contr.
Small					
Head Office			-774		
Branch			-36		
Large					
Head Office			-27		
Branch			-63		

Summary and Conclusion

If we make all the corrections to Table 6 suggested in the text, we end up with Table 8. Under this more realistic set of assumptions we find that the small enterprise share of employment is about 70 percent. This is a decline from the 82 percent that we calculated for the 1969-1976 period, but it is significantly higher than the 37 percent Brookings obtains from its file or the 35 percent we obtained initially from the Brookings file after we had cleaned it of suspect records.

We would expect fluctuations in the small business share of net employment creation in the 65 percent to 75 percent range, and feel that our own 82 percent is on the high side by historical standards due to the rapid growth of smaller enterprises in the 1969-1972 period and the difficulties

Table 8

Revised Components of Employment Change

by Enterprise Size and Type

Enterprise Type	Component: Reg. Birth	New List. Birth	Death	Expan.	Contr.	Net Change
Small						
Head Office	3,327	0	1,258	2,517	1,234	3,352
Branch	0	157	166	87	23	55
Small Total	3,327	157	1,424	2,604	1,257	3,407
Large						
Head Office	948	0	911	1,547	1,096	488
Branch	0	1,746	1,336	1,185	641	954
Large Total	948	1,746	2,247	2,732	1,737	1,442
Grand Total	4,275	1,903	3,671	5,336	2,994	4,849
Small Business Share	78%	8%	39%	49%	42%	70%

experienced by larger ones in this same post-Vietnam period. Looking at the share of net employment growth provided by establishments with 20 or fewer employees, for example, we found[1] that it dropped from its 1969-76 average of 82 percent to 53 percent in 1972-74 and rose again to 65 percent in 1974-76. As mentioned earlier, such fluctuations in the small business share of job creation are due at least as much to the ups and downs of the larger firms as they are to small business behavior or performance. Our figures are also higher because, unlike Brookings, we built our estimates of total enterprise size up from the bottom, based on known employment in U.S. establishments, rather than from D&B's estimates of total employment -- at D&B's suggestion. Our enterprise total size estimates thus tend to be lower than Brookings', placing more jobs in the small-business category. If account were taken of this different approach to estimating size, and we followed Brookings' approach, the estimates of the small business share of job creation in our analyses would probably be in the 75 to 80 percent range -- quite close to those we obtained from the Brookings file, the differences being easily attributable to differences in economic conditions.

The findings in Table 8, and the elaborate process we had to go through to obtain them, raise a disturbing issue. We had to make a lot of estimates to get our results, as did Brookings. We had to make estimates, for example, of:

1. The rate at which newly formed firms were being entered by D&B into its file;
2. The proportion of new branch listings that were, in fact, actual new branches;
3. The average size of spurious deaths due to the Nixie Purge.

We used historical data wherever we could, and obtained as much information

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[1] See Birch and MacCracken, Corporate Evolution: A Micro-Based Analysis (MIT Program on Neighborhood and Regional Change, 1981).

as we could from Dun and Bradstreet, corporate annual reports and SEC 10K forms, and telephone calls, but we were still forced to estimate rather than to simply count.

This is not a subject that should have to rely on estimation. We should know precisely what smaller and larger businesses are doing if we are to assist them properly. Either Dun and Bradstreet must be more careful in how it documents changes in its file, and how it records the age of each establishment, or the government must bolster its efforts to make better use of the records it receives from each business every year, or both. We cannot afford the uncertainty associated with picking our way through a morass of undocumented purges and new listings and imputed records in our efforts to measure the important role that smaller businesses play in job creation.

In the meantime, the analysts of individual firm histories must remain enormously sensitive to the multitude of problems associated with their use. Questions posed should reflect the many inherent limitations of these histories. Company births, for example, are not accuately measured during short intervals. Firm deaths are meaningless during periods when files are being purged. Branch new listings are difficult to separate from branch births during periods of file enhancement, and so forth. This does not mean that the files are useless. It only means that, in any particular time period, they must be used in ways that guarantee that changes in the file are indicative of changes in reality.

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